

# **“Regional Economic Integration for Sustainable Development in Cambodia”**

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**Abstract**

**This working paper discusses the implication of regional economic integration for Cambodia's sustainable development. The ultimate goal of economic integration is reconstruction and development in Cambodia, but the links between ASEAN/AFTA and Cambodia's long-term sustainable development have been paid relatively little attention. What is the nature of regional economic integration? How, and to extent, will joining AFTA affect Cambodia's sustainable development?**

**What are challenges of translating the benefits of regional economic integration effectively and efficiently into sustainable development? What are policy options to meet the challenges of regional economic integration? These are the question that this working paper seeks to answer. Discussions are centered on growth with equity and poverty eradication, human resource development, agriculture and rural development, service and industrial sector development. The main contention of this working paper is that the establishment of policy coherence and coordination within the Cambodia government is the critical factor for the success or failure of regional integration in Cambodia.**

## **Introduction**

**Cambodia embarked on its transition from a command-to a market-oriented economy in the midst of the globalization of the world economy. It has already taken extensive unilateral liberalization measures regarding trade and investment in the pas few yeas. Although full membership in the Association of Southeast Asian Nations (ASEAN) was temporarily postponed in July 1997, Cambodia is committed to integrating itself with the ASEAN economies. The government has also taken steps to prepare for**

accession to the World Trade Organization (WTO). Cambodia is without doubt acceleration the pace of its integration with the regional and world economies.

Although economic integration is expected to bring new opportunities for Cambodia, its also poses new challenges for policy-makers. A handful of developing countries have benefited enormously from integrating themselves with the world economy in the past three decades. Policy-makers in these countries managed to successful translate the benefits of economic integration into raising people's standards of living. A large number of developing countries, however, have not reached same level of success. Some countries apparently have failed to translate the force of globalization and integration into the development of their own countries. Few would disagree that government policies towards economic integration are critical to the success or failure of development in Cambodia.

This paper will discuss the implication of regional economic integration foe Cambodia's sustainable development. The ultimate goal of economic integration is reconstruction and development of Cambodia, but the links between ASEAN/AFTA (the ASEAN Free Trade Area) and long-term sustainable development in Cambodia have been given relatively little attention. What is the nature of regional economic integration, particularly *vis-à-vis* AFTA? How, and

what extent, might joining AFTA affect Cambodia's sustainable development?

What are the challenges to translating the benefited of regional economic integration into sustainable development in Cambodia? What are the policy options to meet these challenges of regional economic integration? There are the question paper seeks to answer.

## **I. Regional Economic Development**

### **1. Concepts of Economic Integration**

Economic integration comprises legal arrangements among nation for economic transactions and activities across boundaries. Regional integration is a type of economic integration in which a set of nations within a certain form preferential arrangements, typically on international trade. The word "preferential" is key to understanding regional integration, as it implies that such agreements are extended to only to the nations, which signed the agreement. Regional integration may be classified in two broad categories: 1) modest regional integration and 2) deep regional integration. Modest integration seeks only a preferential trade arrangement (PTA) or free trade area (FTA). Under a PTA, lower tariffs are imposed on imports from member countries than on imports from the rest of the world. An FTA is one step forward from a PTA, in that tariffs on imports from

members are reduced to zero, whereas those from the rest of the world remain at pre-agreement levels. The ASEAN and FTA is actually a case of modest integration. Deep integration envisages either a customs union, in which members set a common external tariff, or a common market, in which free movement across national boundaries is established for capital, labour, services and firms, in addition to the trade of goods. The single market of the European Union (EU) is an example of deep regional integration. Economic integration can be arranged beyond the regional level. In fact, after the Second World War, multilateral trade agreements have been negotiated and implemented by the General Agreement on Tariffs and Trade (GATT), which evolved recently into its successor, the WTO. The general principle of GATT/ WTO is characterized by non-discrimination, which is stipulated in two clauses: most favored nation (MFN) and national treatment (NT), (WTO 1995). MFN is concerned with non-discrimination among imported goods from different countries. It essentially members are bound to grant treatments to the products of other members which are no less favorable than accorded to the products of any other members countries. NT is concerned which non-discrimination between imported and domestically produced goods. It requires all members to treat imported goods no less favorably than the equivalent

domestically produced goods, once goods have entered the market of member's countries. It is well recognized that tariff reduction base on the non-discriminatory approach of GATT/WTO have been a major driving force in the expansion of world trade in the last four decades. It should be noted that regional trading arrangements such as AFTA involve a discriminatory element against non-members. This is because preferential treatments are applicable only to member countries. In this sense, regional integration contradicts the non- discriminatory principle of MFN treatment in GATT/WTO. However, regional trading arrangement in the form of customs union and FTAs are exempted from the MFN clause under GATT/WTO, for the reason that closer integration within regional countries is expected to promote free trade. In either case, regional arrangements are required to treat non-members no more restrictively than before the arrangement was formed.

## **2. Analytical Framework and Methodology**

Analysis of impacts is not intended to isolate the impact of the Asian crisis from other major events. Rather, it tries to identify some impacts on Cambodia that could be attributed to the Asian financial crisis, and to observe and analyse the changes that have taken place since the crisis began. Three major impacts are



identified and discussed in this paper 1) the impact on the financial sector; 2) the impact on the real sector; 3) the impact on social development.

First, the crisis started with financial turmoil in Thailand, and transmitted rapidly to the financial sector in other crisis countries. Thus reason to begin our analysis by examining whether the contagion spilled over to the financial sector in Cambodia. The impact could take from the withdrawal of foreign capital, credit crunch, or the closure of commercial banks that are affiliated with or owned by foreign banks in the crisis countries.

Second, the experience of the crisis countries revealed that turmoil in financial sector caused a subsequent contraction of the real sector of their countries. Major deterioration of performance in the crisis countries could adversely affect Cambodia's real economy through two channels: 1) the realignment of foreign exchange rates; and 2) the slowdown of economic growth in the crisis countries.

Drastic realignment of foreign exchange rates in the crisis countries could affect the competitive position of Cambodia's goods and services in domestic, regional and world markets. This could potentially affect domestic consumption, production and the flow of foreign trade and investment. In addition, the slowdown of economic growth in the countries could reduce the demand for

Cambodia's exports, and possibly the inflow of foreign private investment from the crisis countries. Furthermore, some domestic services, such as tourism, could be affected by the crisis.

Third, the economic crisis in the region and its contagion in Cambodia could put pressure on the livelihoods of the Cambodian people; affect social development, such as health and education. In particular, the poor and vulnerable groups in both urban and rural areas could be severely hit by the internal and external crisis. For instance the crisis could reduce earning and job opportunities of urban workers on the one hand, and increase the prices of the essential items such as food, medicine and education on the other. In rural areas, migrant workers who live near the Thai border may no longer find as high a demand and wages in Thailand as they used to. The losses of income-generating opportunities in Thailand could motivate them to migrate to towns and in Cambodia to seek alternative earning opportunities.

### **3. Impact on the Real Sector of the Economy**

The Asian crisis was triggered by massive and rapid outflow of private capital from the crisis countries. In Thailand, for instance, net private capital inflows recorded an annual average of 10 percent of GDP from 1995, and remained around 9 percent of GDP in 1996 (Table 1). However, the inflow of private foreign capital

reversed dramatically in 1997, such that net capital outflows accounted for 13 percent of GDP. A similar pattern before and after July 1997 was observed in the other crisis countries, such as Malaysia, the Philippines, and Indonesia, though the extent was much less than Thailand.

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**Table 1. Private capital flows (percentage of GDP)**

	1983-88	1989-95	1996	1997
<b>Cambodia</b>	-	-	5.4	4.9
<b>Countries most affected by the crisis</b>				
<b>Thailand</b>	3.1	10.2	9.3	-10.9
<b>Malaysia</b>	3.1	8.8	9.6	4.7
<b>Indonesia</b>	1.5	4.2	6.3	1.6
<b>Philippines</b>	-2.0	2.7	9.8	0.5
<b>South Korea</b>	-1.1	2.1	4.9	2.8
<b>Countries less affected by the crisis</b>				
<b>Singapore</b>	5.0	3.8	-10.1	-5.5
<b>Taiwan</b>	0.2	-4.0	-3.2	-3.8
<b>China</b>	1.2	2.5	4.7	3.7

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The drastic outflows of private capital created a vicious circle in the crisis economies, as their currencies depreciated dramatically and equity prices plunged.

A larger number of commercial banks and financial institutions suffered from soaring short-term unheeded foreign debt, and mounting outperforming loans.

Government liquidated insolvent financial institution to restore confidence in the economy. The collapse of the financial sector, coupled with tight monetary policies

to curb inflation, pushed up market interest rates in the crisis countries. This had adverse impact on the real sector in the economy many non-financial firms suffered from credit crunch and faced difficulty finding credit even for ordinary operations of production and export. Domestic consumption and investment consequently contracted, and unemployment soared.

Cambodia also experienced a decline in private capital inflows in 1997. However, the scale and the speed of the decline were modest relative to the experience of the crisis countries. For instance, net private capital inflows to Cambodia declined from \$170mill. in 1996 to around \$150mill.in1997. In percentage terms relative to GDP, this was a decline from 5.4 % in 1996 to 5.0 % in 1997. The extent of the decline was much smaller than that in Thailand, Malaysia and other severely affected Asian countries. The adverse impact of the Asian crisis instead appears to have been felt more strongly in 1998. First, even though total private capital inflows recovered in the first haft of 1998, the proportion of short-term loans increased relative to long-term investment. According to the estimates by the National Bank of Cambodia (NBC), net private capital inflows increased by 30 %from\$ 89 mill. in the first semester of 1997 to \$ 116mill. in the first semester of 1998. How ever, the expansion came from an increase in other net investment,

including short-terms currency transactions, deposits, loans and trade credit. In contrast, direct investment, which had been a major source of private capital inflows into Cambodia until 1996, continued to decline from \$ 108 million in the first semester of 1997 to \$ 90 million in the first semester of 1998. This indicates that the proportion of short-term private capital inflows relative to long-term inflows has been increasing from 1997 to 1998. Second, the Asian crisis has gradually been putting pressure on the banking sector in Cambodia. One of the most notable developments was the decline of foreign currency deposits after mid-1997. Foreign currency deposit expanded rapidly after the operation of private and foreign banks was liberalized in 1991. Since then, foreign currency deposits have comprised the major part of bank deposits in Cambodia, accounting for 90 to 95 % of total deposits in the past few years. However, this trend reversed after July 1997. The total value of foreign currency deposits peaked in February and March 1997, and then started to decline. The decline of foreign currency deposits continued from July 1997 to August 1998. Finally, unlike Thailand and other crisis countries, Cambodia did not experience closure of commercial banks until mid-1998. Immediate contagion of the financial turmoil thus did not take place in Cambodia. However, in the second half of 1998, two Thai-owned commercial banks

closed their offices in Cambodia, perhaps reflecting the restructuring of banking activities undertaken in Thailand.

**Foreign trade:**

Despite the losses of competitiveness of Cambodia's goods and services in the second semester of 1997, the Asian crisis did not affect immediately the export performance of Cambodia. In fact, Cambodia's domestic exports rose by 49% and 35% in the third and fourth quarters of 1997 relative to 1996. This was mainly due to the expansion of garment exports during that period, when Cambodia was granted GSP status for garments from the EU and the United States. This together with generous investment incentives and relatively low labour costs, provided strong incentives for foreign investor to locate their garment factories in Cambodia. In addition, the European and the US economies, which are the main destination of garment exports, have not yet been affected severely by the crisis. The adverse impact of the crisis, however, appears to have become apparent in 1998. Domestic exports declined in the first and second quarters of 1998 relative to the previous year. This may reflect the fact that some major Cambodia exports items, other than garments, experienced a major decline during this period. As is reported below, the volume of exports of wood-related products declined sharply in first

semester of 1998. Interviews with managers of wood-related companies revealed that their exports had faced tough price competition with products from the crisis countries, which had become much cheaper. With regard imports, the loss of competitiveness up to January 1998 was expected to increase Cambodia's imports, as the appreciation of the real exchange rate (RER) against Thailand indicates. On the other hand, the decline of domestic expenditures and income since July 1997 due to the domestic political crisis would be likely to decrease demand for imports. The impact on total imports would thus depend on the extent to which the former was dominated by the latter. Cambodia's import performance does not appear to have shown a notable change in the second semester of 1997. This is presumably a reflection of the mixed impacts of the two factors discussed above. In addition, Cambodia's imports from the crisis countries did not surge, partly because the severe credit crunch had disturbed normal export activities in the crisis countries, which made it difficult to take advantage of the gain in competitiveness. Cambodia's retained imports, however, declined in the first half of 1998. The recent decline may reflect the depreciation of the riel and the US dollar against regional currencies in the first half of 1998, as the regional currencies bounced back after February 1998. In addition, a sharp decline of economic growth in 1997

and 1998 contributed to the decline of import demand of first half of 1998.

#### **Foreign direct investment (FDI)**

The inflow of FDI to Cambodia was affected by changes in its competitive position and the slowdown of growth in the crisis countries. The depreciation of currencies in the crisis countries reduced their unit labour costs in dollar terms, even taking into account high inflation in some countries. Foreign investor looking for an export base considered Cambodia to be less attractive than before. In addition, the slowdown of economic growth in the crisis countries made their investor more cautious about investing in overseas, as they faced problems of credit crunch at home. Official data confirm the adverse impact of the crisis on foreign investment discussed above. According to the NBC, the net inflow of FDI plunged \$ 200 million in July, down from \$ 290 million in 1996. On a quarterly basis, the inflow of FDI revealed a downward trend from July 1997 to the second quarter 1998. In fact, the declining trend of FDI had already began in 1996, well before the Asian crisis perhaps reflecting foreign investor's perception about the deterioration of Cambodia's investment climate since 1996.

Another source of information regarding foreign investment indicates changing patterns of investment by country and region. According to data from the



Cambodia by ASEAN countries, Hong Kong, Taiwan and South Korea since 1995.

This pattern has not been greatly affected by the Asian crisis. The extent of decline investment from ASEAN countries (Indonesia, Malaysia, Singapore, Thailand and Vietnam) was smaller than that of total foreign investment. Instead, a larger slowdown was observed in total investment from other Asian and Pacific countries, such as Hong Kong, Taiwan and South Korea.

#### **4. Impact on the Real Sector**

The real sector of Cambodia's economy experience steady growth until mid-1997. Real GDP increased by an average annual rate of 6% between 1991 and 1996. This reasonable performance was led primarily by the expansion of the industrial and the service sectors, even though the agricultural sector continues to play a dominant role in Cambodia's economy. Agricultural comprised of 43 % of real GDP and absorbed almost 80 % of total employment in 1996. Cambodia has taken several measures to liberalize international trade since the early 1990. For instance, tariff lines have been streamlined, and various quantity restrictions have been abolished. Cambodia thus maintains a liberal trade regime. Cambodia's foreign trade expanded rapidly between 1992 and 1995, stimulated by trade liberalization

and the steady growth of the domestic economy. High economic growth in neighboring countries also contributed to the expansion of trade. This has, however, led Cambodia to run sizeable currency account deficits since 1993, deficits which have accounted for around 12 to 16 % of GDP between 1993 and 1996. A large proportion of the current account deficit was met by the comparably large amount of unilateral transfers, in the form of foreign aid and grants, during that period.

## **II. Potential Impact on Trade, Investment and Growth in Cambodia**

### **1. Trade Patterns**

The total value of international trade in Cambodia increased dramatically as a result of various trade liberalization measures undertaken early in the 1990s. In 1995, the exports and imports of goods and services in Cambodia accounted for between 35 and 50 % of GDP respectively (table 2.1). These figures are similar to those of Vietnam, the Philippines and Thailand in the same year. Cambodia implemented trade liberalization only recently, but it has already achieved a fairly open trade regime. In Cambodia, the account deficit position is better than that of Laos 13 % and Vietnam 10 %. A large amount of unilateral currency transfer in the form of grants and non-repayable external assistance, which accounted for 10 % of GDP, helped offset the large Cambodia trade deficit.

**Table 2-1 trade and current accounts 1995 (millions of dollars)**

Countries	Goods and services		Net factor	Net transfer	balance of current a/c
	Exports	Imports	income		
<b>Cambodia</b>	969 (35)	1,375 (50)	-57 (-2.1)	277 (10.0)	-186 (-7)
<b>Laos</b>	445 (25)	666 (50)	0 (0.0)	-3 (-0.2)	-224 (-13)
<b>Myanmar</b>	1,120 -	1,669 -	-101 -	312 -	-339 (-13)
<b>Vietnam</b>	7,272 (36)	9,459 (46)	-310 (-15)	477 (2.3)	-2,021 (-10)
<b>Indonesia</b>	51,160 (26)	53,244 (27)	-5,778 (-2.9)	839 (0.4)	-7,023 (-4)
<b>Philippines</b>	26,795 (36)	33,317 (45)	3,662 (4.9)	880 (1.2)	-1,980 (-3)
<b>Malaysia</b>	81,692 (96)	86,248 (101)	-3,673 (-4.3)	163 (0.2)	-4,147 (-5)
<b>Thailand</b>	70,292 (42)	82,219 (49)	-2,114 (-1.3)	487 (0.3)	-13,554 (-8)
<b>Singapore</b>	148,394 (177)	134,028 (160)	1,615 (1.9)	-888 (-1.1)	15,093 (18)

## 2. An Analysis of Comparative Advantage

Land and population, in term of economic, comprise the fundamental factor endowments for the economic activities of a country. The Heckscher-Ohlin theory of international trade posits that the relative abundance of factor endowments determines comparative advantage, and hence trade patterns, of countries. Cambodia is one of the least-populated and relatively land-abundant countries in the regional. In 1995, Cambodia had 57 people per square kilometer. The share of arable land in total land area was 22 % the highest after Malaysia's 34 %. It should be note, however that Cambodia's population growth in 1995 was 2.7 % one of the highest in the region. In the long-term, this trend is likely to decrease the relative land abundance of Cambodia. Another factor, which constrains land use in

Cambodia, is the land area covered by land mines. Cambodia is also endowed with freshwater resources. In 1995, Cambodia held the largest amount of freshwater resource in cubic meters per capital in the region, except for Laos.

### **3. Foreign Investment Pattern.**

Cambodia's liberalization policy was extended to foreign investment in the early 1990s. Cambodia's investment law entered into force in 1994, offering some of the most generous incentives to investor in the region. The liberal investment regime attracted a significant amount of foreign direct investment (FDI) in the 1990s. FDI in Cambodia increased from \$ 80 million in 1994 to \$ 240 million in 1996 (World Bank 1997). Inward FDI stock the accumulation of annual FDI inflow in Cambodia was \$ 236 million, or 8.5 % of GDP in 1995 (Table 2.2). The percentage share of FDI stock relative to GDP in Cambodia was higher than that of Vietnam 2.0 % and Brunei 1.2 %. However, it was still far below that of other ASEAN countries, which early 1990s. FDI performance by source country is of considerable interest to researcher and policy-makers who are concerned about whether joining AFTA will affect investment patterns in Cambodia.

**Table 2.2. Inward Foreign Direct Investment, 1995**

	FDI inward stock Values million of \$	FDI inward stock As % of GDP

<b>Cambodia</b>	<b>236</b>	<b>8.5</b>
<b>Laos</b>	<b>225</b>	<b>12.8</b>
<b>Myanmar</b>	<b>38</b>	<b>-</b>
<b>Vietnam</b>	<b>397</b>	<b>2.0</b>
<b>Indonesia</b>	<b>50.755</b>	<b>25.6</b>
<b>Philippines</b>	<b>6.852</b>	<b>9.2</b>
<b>Thailand</b>	<b>16.775</b>	<b>10.0</b>
<b>Malaysia</b>	<b>38.453</b>	<b>45.1</b>
<b>Singapore</b>	<b>55.491</b>	<b>66.3</b>
<b>Brunei</b>	<b>62</b>	<b>1.2</b>

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Source: United Nations, World Investment Report 1996

#### **4. Joining AFTA: Potential Impact on Trade, Investment and Growth**

An overview of patterns of foreign trade and investment in Cambodia revealed that ASEAN countries were by far the largest trading partners as well as primary investor in Cambodia. Joining AFTA implementing the Common Effective Preferential Tariffs (CEPT) scheme is, therefore, likely to have significant implication for Cambodia trade, investment and economic growth. The long-term impact of joining AFTA on trade in Cambodia could be discussed within the framework of trade diversion and creation. The analysis in Section 2.2 made it clear that Cambodia's trade with ASEAN countries accounted for a large proportion of total exports and imports. This may indicate that the potential for trade diversion will be low in the medium to long term. Cambodia's initial package

of CEPT discussed in Section 2.1 indicates that the government takes active rather than passive approach towards tariff reductions, in comparison with new ASEAN member such as Laos, Myanmar and Vietnam. This means that Cambodia will be able to enjoy lower tariffs on much wider range of products than the new member countries. Cambodia is thus likely to have a high chance of benefiting from the trade creation through stimulated consumption, demand for intermediate input, and herence international trade with ASEAN countries. Cambodia's entry to AFTA may also stimulate certain types of foreign investment. As Robertson and Pohoresky (1998). Discuss in their report, joining AFTA will increase incentives for investor from non-ASEAN countries to establish a production base in Cambodia to supply their products to ASEAN markets. This is because exports from Cambodia to other ASEAN countries will enjoy lower tariffs under CEPT than exports from outside ASEAN. Although this is likely, should be noted that various conditions need to be met for Cambodia to become a platform for this type foreign investment. For instance, the products of non-ASEAN multinational firms need to be on the inclusion list of CEPT; tariffs rates of these products ought to be less than 20 % and 40 % ASEAN content is required. In addition, new ASEAN members such as Laos, Myanmar and Vietnam are competitors of Cambodia and could be equally

attractive to investors. Menon 1997 pointed out some “indirect” of benefits of joining AFTA, which are unique in the case of transitional economies such as Laos. These indirect benefits of joining AFTA are also relevant to Cambodia. First, joining AFTA will send a signal to foreign investors that administrative systems will have to be change to satisfy the investment environment, but will also force the government to actually reform its governing systems to comply with the requirements of membership. Second, a small country with weak bargaining power in trade negotiations, such as Cambodia, could benefit from joining ASEAN perhaps more than large developing countries. Asian’s dispute settlement mechanism, established in 1996, could enable a small country like Cambodia to be able to negotiate on an equal footing with larger ASEAN countries. The above analyses suggest that Cambodia’s entry to AFTA is likely to bring benefits to Cambodia though the expansion of trade and investment. In addition, there are indirect benefits for Cambodia, which are intangible yet, significant in establishing a market economy with good governance. All these will stimulate economic growth in Cambodia, and the benefits ill become more apparent in the long term, as Cambodia’s economic integration with the regional economies through AFTA deepens. These benefits will not be automatically translated into sustainable

development however; indeed there are some major challenges for Cambodia to overcome if it is to harness the driving force of regional integration to achieve sustainable development.

### **III.Challenges of Linking Regional Integration to Sustainable Development**

The goal of sustainable development is to raise the living standards of Cambodia steadily, without leaving an extra burden for next generation. As the goal is centered around people's living standards, it necessarily involves multi-dimension objectives: 1) income growth with equity, particularly income growth of the poor; 2) universal education; 3) improvement of health and nutrition; and 4) regeneration of the environment. From this perspective, economic integration is viewed as one of various means to achieve sustainable development in Cambodia. In the policy context, any policy measures toward economic integration must be consistent with achieving the goal of development, namely raising the standard of living of Cambodia.

#### **1. Economic Growth with Equity**

Economic integration will promote economic growth and raise per capita income at the national level. However, there is no guarantee that the benefits of economic integration will be shared broadly. It might happen that a small number of rich people in Cambodia would enjoy a large portion of benefits from economic integration, while the living standards of the poor and the vulnerable would increase only marginally or remain at same level. Achieving equity of distribution can improve the standard of living of Cambodia for at least three reasons. First,



the eradication of poverty will be most effective and efficient if the benefits from economic growth actually reach the poor. Second, equity tends to curb social tensions, which often cause political and economic instability and consequently undermine the potential for economic growth. Third, it is not appropriate on ethical grounds to impoverish already poor people for the benefits of the rich.

## **2. Agricultural and Rural Development**

There are several reasons to highlight the priority for agricultural and rural development in Cambodia. First, a majority of Cambodians live in rural areas, and most of them are involved in agriculture, fishing or forestry. For instance, in 1996 rural households were estimated to make up 87 % of total households in Cambodia.

In rural areas, employment in the agriculture, fishing and forestry sectors accounted for 88 % of total employment in 1996. Second, agricultural production accounted for 42.7 % of real GDP in 1996 the highest share followed by the service 37.4 % and industrial 19.9 % sectors. Third, the living standards of rural people in Cambodia are extremely low relative to those of people in urban areas. For instance, the highest incidence of poverty was found in rural areas, where of individuals lived below poverty line, whereas only 11 % of individuals in Phnom Penh fell below the poverty line. This suggests that agricultural and rural development will have significant impact on the eradication of poverty, achieving equitable distribution, and thus improving the living standard of a large number of

Cambodia. The importance of agricultural sector development has also been reported in a large number of empirical studies other countries. These studies found that agricultural development had contributed to the development of other sectors through various channels.

### **3. Development of the Industrial and Service Sector**

The industrial and service sectors have shown fairly good growth since the beginning of Cambodia's transition to market economy in the early 1990s. Average annual growth rates of the industrial and service sectors between 1991 and 1996 were 11.9 % and 8.4 % respectively. The high rates of growth in these sectors transformed the production structure of Cambodia at rapid pace. The share of agriculture declined in real term from 51.8 % in 1991 to 42.7 % in 1996, whereas that of industry increases from 15.5 % in 1991 to 19.9 % in 1996, and that of services from 33.1 % in 1991 to 37.4 % in 1996. While the overall performance of industrial development in Cambodia was impressive, regional integration may still pose challenges to Cambodia's industrial and service sector. The major challenges are: 1) to develop agriculture-related industries; 2) to maximize employment, maintain labour standards, and review benefits in the unskilled, labour-intensive industries; and 3) to assist small- and medium-size enterprise (SMEs).

### **Domestic conditions and constraints**

**Industrial development maximizes benefits for a country when it is based on comparative advantage. Industrialization in Cambodia thus should be linked to the country's potential comparative advantage.**

**The agricultural sectors is one in which Cambodia enjoys potential comparative advantage. There are several advantages to developing the agro-industry and the food-processing industry in Cambodia. First, it will create employment and substitute imported processed agriculture products for domestic products. In addition, it will strengthen backward links to the agricultural sectors. The backward links will increase the demand for agricultural products, which will be an incentive for a large number of farmers in rural areas to expand production and improve productivity. This will contribute to eradicating poverty and achieving equitable distribution of income growth in rural areas will in turn create the demand for domestic manufactured good and services.**

**Despite its potential capacity for development, the agricultural sector (including food-processing industries) has not attracted much investment. Among total investment projects approved by the Cambodia Investment Board (CIB) between August 1994 and March 1998, the agricultural sector accounted for 11 % of total registered capital, 6 % of total fixed assets, and 8 % of total employment created. The challenge to the government is to determine how to facilitate development in the agriculture- related industries.**

**The development of the manufacturing industry has started and gathered momentum in the labor-intensive, light manufacturing industries, particularly garments. The garment industry alone accounted for \$266 million if registered**

capital, and created 165,000 jobs between August 1994 and 1998. This sector has already revealed strong comparative advantage the ASEAN region. With investment increasingly coming into Cambodia, This sector is expected to expand Cambodia's exports, create jobs, and generate income for a large number of Cambodians. The role of government here therefore may be to build a sound monitoring mechanism to ensure that this sector will actually provide the expected benefits listed above.

#### **4. Fiscal Policy Imposing Strict Budgetary Discipline**

The slump in tourism, the decline of customs revenues, and the suspension and termination of foreign aid after July 1997 cut into government revenues. According to the Ministry of Economy and Finance, government revenues from taxes on tourism alone dropped by 25 % in 1997, down from \$ 100 million in 1996. The government responded to the decline in revenues by introducing stringent budgetary discipline. Efforts were made on both expenditure and revenues sides of public finance. With regard to expenditures, the government in October 1997 cut spending on civil administration and expenditures on operation and maintenance by 20 % to balance the national budget. The council of Ministers also imposed a ban on the free use of mobile telephones by government officials (other than Ministers) in an attempt to economise government resources.

Budgetary discipline was also pursued by fiscal reforms intended to increase national revenues. The 1998 budget included fiscal reform measure aimed at broadening the tax base and improving the capacity of tax collection. It also implemented the Law on Taxation, which contained several revenues-enhancing measures. The introduction of value-added tax (VAT) was a notable development among those policy measures. VAT came into force on 1 January 1999, with the

rate set at 10 %, replacing turnover taxes that had previously been levied. VAT is applied to about 2,000 large firms with variable taxable income, except for food and staple products. Some types of business, such as commercial banks, medical clinics, postal services, non-profit activities and insurance services, are exempt from VAT.

#### **5. Money Policy Restoring Macro-Economic Stability**

The depreciation of the Riel (Cambodia currency) against the dollar began July 1997, and continued for about one year until the national election in July 1998. The NBC intervened occasionally in the foreign exchange market to stabilize the fluctuations of the Riel through the use of auctions of dollars. This instrument was used to defend the Riel against speculative attacks. A notable intervention was undertaken in July 1998, prior to the July national election, when the exchange rate passed 4,000 Riel to the dollar. To maintain the value of the Riel, the NBC bought \$ 400,000 worth of Riel in dollar auctions. This intervention was fairly successful in restoring stability in the foreign exchange market, as the Riel bounced back to 3,900 Riel to the dollar and has remained stable at 3,800 since then. The NBC issued two regulations in 1998 to stem the outflow of dollars and increase confidence in the banking sector. The first regulation, passed in August 1998, stated that the transfer of foreign currency overseas must be performed by the NBC. The second regulation, also issued in August 1998, stipulated that commercial banks financial institution had to keep foreign currency deposits received from clients and inter-bank deposits for use within Cambodia.

### **IV. Policy Options in Sustainable Development**

#### **1. Government Policies**

Although government policies should be coherent, this is often not the case in reality. Incoherent government policies tend to prevail on a larger scale in developed countries .the economic and social costs of incoherent public policies are tremendous. Incoherent government policies waste a huge amount of scarce human and financial resources without achieving their objectives. Developing countries with strictly limited resources, such as Cambodia, simply cannot afford this. Thus it is imperative for the Cambodia government to investigate whether, and to what extent, new policy measures are consistent with, and complementary to, other government policies. By so doing, the objectives of the new policies are achieved most effectively without undermining the goals of other government policies. Policies toward Cambodia's regional integration should be considered in this context.

## **2. Policy Coordination**

Policy coherence will never emerge without a high level of coordination among government ministries. As Kaplan 1997 notes, one of the ongoing challenges in the Cambodian government is “ building inter- ministerial arrangements that can effectively and efficiently coordinate to generate policy options, develop and share information, and provide technical input to guide Cambodia's participation in ASEAN's various economic initiatives.” Institution building and legal reform are pre-conditions for enhancing the coordination capability of the Cambodian government. The role of National AFTA Unit and Internal Coordination Network (ICN). Which were created for inter-ministerial coordination purposes, are critical for generating a coherent set of policy packages geared toward regional economic integration. Coordination may be necessary between the public and the private sector as well. ASEAN preparations so far appear to be limited to those within the

government. It is not clear to what extent the private sector in Cambodia has been informed about the government's policy stance towards AFTA. As the private sector will be exposed to stiff competition within the region, informed about AFTA itself or about the competition within the region, information of this sort will be helpful for its decision-making in preparation for AFTA. The public sector should also benefit from exchanging views with the private sector to generate a coherent policy package towards AFTA.

## **V. Conclusion & Remarks**

The present paper seeks to discuss what challenges economic integration will pose to achievement of sustainable development in Cambodia. For this purpose, the paper first made clear the concept of regional economic integration, and identified foreign trade and investment as the key variable which will be directly affected by Cambodia joining AFTA. It then looked at the current patterns of foreign trade and investment in Cambodia. There were two main findings:

- ASEAN countries were by far the largest trading partners for, as well as major investors in Cambodia. This indicates that Cambodia's membership in ASEAN and AFTA is likely to have significant economic implications for Cambodia.
- Cambodia's comparative advantage was revealed in natural resource-based products and labor-intensive manufacturing products. A comparison with neighboring countries indicates, however, that Cambodia's potential comparative

advantage may lie in agricultural and agro-processing products, a sector which has not yet been well developed. The main purpose of this paper was to discuss the challenges of translating the benefits of regional integration into sustainable development. It was emphasized that regional economic integration is a means of raising the living standards of Cambodians, the goal of sustainable development. The first challenge is to achieve high economic growth with equity. Cambodia's development will not be sustainable unless the benefits from regional integration and economic growth are broadly shared, particularly by the poor. A key policy for the maintenance of equity is public investment in human resource development, particularly in universal education and health. Our comparative study revealed that public investment in education and health in Cambodia was much lower than that in other ASEAN countries. A challenge to the government is, therefore, how to mobilize limited resources to fill the existing gap in human resource capacity between Cambodia and the ASEAN countries.

The second challenge is to promote agricultural and rural development. Agricultural products are already included in the CEPT scheme under AFTA, and thus will be exposed to competition with the ASEAN economies in the long term. Our study found, however, that the productivity of agricultural products in



Cambodia was in general far below the best practice countries in the region. Farmers in Cambodia have faced serious constraints, such as the lack of access to various inputs, finance, technology and information. Cambodia's potential yet revealed a comparative advantage in agricultural products, where Cambodia's potential comparative advantage appears to exist. A major challenge to the government is how to articulate AFTA/CEPT strategies to facilitate agricultural and rural development.

The third challenge is industrial and service sector development. These sectors have been leading sectors for economic growth since economic liberalization began. They offer different challenges to the government from those in the agricultural sector. The government should ensure that the development of these sectors actually contributes to raising Cambodian's standard of living. Setting quality standards for goods and services is a critical step for the government to make market mechanisms work better.

Key factors in articulating regional integration policies in Cambodia are policy coherence and coordination. The multi-dimensional objectives of sustainable development require the government to articulate integration policies, which are coherent with other policies serving different objectives. This policy coherence will

not emerge without coordination among the ministries, and also coordination between the private and public sector. Regional integration will contribute most effectively and efficiently to sustainable development in Cambodia if these conditions are met.

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