

CAMBODIA ECONOMIC UPDATE



Enhancing Export Competitiveness The Key to Cambodia's Future Economic Success

SELECTED ISSUE

The Garment Sector in Perspective



WORLD BANK GROUP

OCTOBER 2016

**Enhancing Export Competitiveness
The Key to Cambodia's Future Economic Success**

Cambodia Economic Update

October 2016



@ All rights reserved

This Cambodia Economic Update is a product of the World Bank Group.

The findings, interpretations and conclusions expressed in this update are those of World Bank staff and do not necessarily reflect the views of its management, Executive Board, or the governments they represent.

The World Bank Group does not guarantee the accuracy of the data included in this work.

Preface and Acknowledgements

The Cambodia Economic Update (CEU) is a product of the staff of the World Bank Group. It was prepared by Sodeth Ly and incorporates contributions by Miguel Eduardo Sánchez Martín, both at the Macroeconomics and Fiscal Management Global Practice (MFM GP). Linna Ky served as research assistant. The team worked under the guidance of Mathew A. Verghis, Practice Manager, MFM GP. The team is grateful for the comments, advice and guidance provided by Ulrich Zachau, Country Director, Inguna Dobraja, Country Manager and Shabih Ali Mohib, Program Leader.

The CEU is produced bi-annually to provide up-to-date information on macroeconomic developments in Cambodia. It is published and distributed widely to the Cambodian authorities, the development partner community, the private sector, think tanks, civil society organizations and academia. The update is timed to coincide with the six-monthly publication of the East Asia and Pacific Economic Update by the East Asia MFM GP of the World Bank.

We received valuable inputs, comments and suggestions from Ahmad Ahsan, Lead Economist, East Asia and Pacific Chief Economist Unit, while the poverty section was contributed by Obert Pimhidzai and Kimsun Tong, at the Poverty Global Practice. The report also benefited from the advice, comments and views of various stakeholders in the Royal Government of Cambodia (RGC), the private sector, development partner institutions and academia. The team is very grateful for their time and inputs.

We are also grateful to the Cambodian authorities, in particular the Ministry of Economy and Finance and the National Bank of Cambodia for their cooperation and support in the preparation of this CEU.

The World Bank Cambodia Office Communications Team, comprising Saroeun Bou and Sophinith Sam Oeun prepared the media release, web display and dissemination.

For information about the World Bank and its activities in Cambodia, please visit our website at www.worldbank.org/cambodia.

To be included in the email distribution list of the CEU and related publications, please contact Linna Ky (lky@worldbank.org). For questions on the content of this publication, please contact Saroeun Bou (sbou@worldbank.org).

Table of Contents

A. Executive Summary.....	1
B. Recent Economic Developments.....	6
An overview.....	6
The real sector.....	6
a) Garments.....	6
b) Footwear	8
c) Construction and real estate.....	8
d) Tourism	9
e) Agriculture	10
Poverty	12
The external sector	13
a) Merchandise exports	13
b) Services and transfers receipts	14
c) Merchandise imports.....	14
d) Foreign direct investment.....	15
Inflation.....	15
The monetary sector.....	16
a) Monetary aggregates, interest rates and exchange rates	16
b) The banking sector	17
c) Microfinance.....	18
The fiscal sector	19
a) Revenue composition.....	20
b) Expenditure composition	20
c) Fiscal balance.....	21
C. Outlook and risks.....	22
D. Key messages and policy options	22
E. Selected Issue – Cambodia’s Garment Sector in Perspective	24
Cambodia: Key Indicators	41

Executive Summary

Cambodia's economic activity continues to expand, led by solid growth in garment exports and strong construction activity. Real growth is projected to reach 7.0 percent in 2016, in line with the resilient performance across the region. The economy is projected to sustain its high growth trajectory, expanding at 6.9 percent in both 2017 and 2018 propelled by exports and government consumption. The agriculture sector is expected to improve slightly due to better weather conditions this year and to expand gradually in the near term, thanks to concerted efforts by all stakeholders, in particular the public sector. Risks, however, include potential uncertainty related to commune and general elections in 2017 and 2018, respectively, a sharp decline in the construction and real estate sector, fallout from a rise in US interest rates, regional tensions and slower global growth. Although severe drought caused by El Niño is a challenge, the downward trend of poverty is expected to continue over the next few years, albeit driven mainly by the garment, construction, and services sectors. The agriculture sector, which was the main driver of poverty reduction in the past has recently eased.

Recent developments

Real growth is projected to reach 7.0 percent in 2016, slightly higher than an earlier estimate of 6.9 percent. Garment exports, which started to accelerate in the second half of 2015, maintained their high growth trajectory through to mid-2016, rising by 10.5 percent (in value terms) year-on-year, compared with 7.8 percent during the same period last year. The return of more stable industrial relations supported by a participatory minimum wage-setting mechanism and initial achievements in gradually integrating higher value addition underpinned by recovery in the Euro area appear to have helped the garment industry grow despite US dollar appreciation.

In 2016, strong activity in the construction sector has continued; however, prolonged expansion of the construction sector has

increased risks associated with the construction boom. Investor appetite for construction and real estate investments remains strong, resulting in an acceleration in the value of construction project approvals, reaching US\$6.8 billion with over 1,000 projects approved by mid-2016 alone, compared with US\$3.3 billion with about 2,000 projects for the entire year in 2015. Imports of construction equipment and materials are rising. Imports of steel (in volume terms) remain high, at 42.4 percent year-on-year during the first half of 2016. Given the prolonged expansion of the construction and real estate sector, timely migrating the risks associated with the existing construction boom is highly recommended.

While continuing to grow, international arrivals have decelerated. Total tourist arrivals in the first half of 2016 eased to a 2.6 percent year-on-year increase, compared with a 4.6 percent increase in the same period last year. It appears that arrivals to Cambodia continue to be largely attracted by the Angkor Wat complex although the country is endowed with countless historical, cultural and natural destinations.

Due to better weather conditions, the agriculture sector is likely to marginally expand this year. While improvements in production and yield remain to be seen, the cultivation of rice crops -- which account for 60 percent of the agriculture sector's value addition in the gross domestic product -- expanded by 13.5 percent during the first eight months of this year, compared with the same period last year. Depressed agriculture commodity prices, however, continue to exert pressures on agriculture exports.

Resilient exports and depressed oil prices contributed to a narrowing of the trade deficit, supporting the country's overall external position. The current account deficit (excluding official transfers) is projected to narrow slightly to 10.2 percent of GDP in 2016, compared with 10.6

percent in 2015. This is being mainly financed by continued strong FDI inflows, projected to reach US\$1.7 billion in 2016, or 8.5 percent of GDP. Rapid gross international reserves accumulation continued, reaching US\$6.4 billion (or 5.4 months of prospective imports) by mid-2016, compared with US\$5.6 billion in 2015.

Financial deepening has accommodated growth while continued strong internal demand has resulted in rising inflationary pressures. Although there are signs of slowing, in particular in the micro-finance sector, the banking sector's credit growth remained high at 26.9 percent year-on-year by mid-2016, similar to that of 2015. Improved confidence may have attracted private sector deposits which accelerated to 19.3 percent year-on-year by mid-2016, from 16.6 percent in 2015. The loan-to-deposit ratio remains high, at 97 percent. Continued strong domestic demand, boosted by consumption with vehicle imports rising at 29 percent year-on-year (in value terms) pushed up inflationary pressures resulting in an increase in the consumer price index (CPI) to 3.3 percent year-on-year by mid-2016, compared with 2.8 percent at end-2015. The Cambodian riel (CR) has recently depreciated against the US dollar, the Thai baht and the Vietnamese dong. The riel/US dollar exchange rate reached CR 4,080 in June 2016, compared with CR 4,050 in December 2015. The real effective exchange rate has also depreciated.

After several years of fiscal consolidation, fiscal policy became expansionary in 2016, while strong revenue collection has continued. In 2016, public outlay is projected to rise, reaching 21.7 percent of GDP, compared with 20.5 percent of GDP in 2015. Collection remains remarkable, projected to achieve 18.8 percent of GDP, compared with 18.5 percent of GDP in 2015. The overall fiscal deficit (including grants) is therefore expected to widen to 1.2 percent of GDP in 2016, compared with 0.1 percent of GDP in 2015. Cambodia's debt distress rating in the latest World Bank/IMF Debt Sustainability Analysis conducted in 2016 remained low, largely underpinned by the

overriding principle of borrowing only on concessional terms.

Over the past decade, Cambodia has achieved dramatic gains in terms of poverty reduction, driven by higher agricultural prices, an expansion in land under cultivation and increases in yields. Rural households have reaped the benefits of growth in the agriculture sector, while in recent years urban households have benefitted from the expansions of the garment and construction sectors.

Outlook

Looking ahead, economic growth remains favorable. Growth is projected to be sustained at 6.9 percent in both 2017 and 2018, partly buoyed by rising government spending. On the production side, solid garment exports should continue to boost growth while the construction sector is expected to slow only gradually. The tourism sector may expand modestly due in part to newly established direct flights and a number of initiatives to boost tourist arrivals. The agriculture sector is anticipated to improve slightly due to better weather conditions this year and to expand marginally in the near term, thanks to concerted efforts by all stakeholders, in particular the public sector to promote programs on seeds and irrigation. In the medium term, the favorable outlook is likely to continue, strategically underpinned by regional integration.

Poverty reduction in Cambodia has been resilient to various economic shocks in the past. Further reductions of poverty are expected for both urban and rural households throughout 2015-16, but with a different set of drivers than previously. For urban households poverty reduction will be driven by growth in the construction, garment and services sectors. For rural households there has been an increase in the sources of non-agriculture income. Agriculture now constitutes only 25 percent of income of the bottom 40 percent in rural areas and this diversification has cushioned households from the impact of declining food prices. However, the

decline in food prices will still deprive households a previous source of income growth. Thus, the pace of poverty reduction is anticipated to be slower than in previous years.

Risks to this outlook include potential uncertainty related to commune and general elections in 2017 and 2018, respectively, a sharp decline in the construction and real estate sector, fallout from a rise in US interest rates, regional tensions and slower global growth.

Key messages and policy options

Economic diversification is important through reforms to improve competitiveness.

The economy remains largely dependent on narrowly based exports with garment (and footwear) exports accounting for about 80 percent of total merchandise exports. Enhancing competitiveness is therefore key to ensuring Cambodia's future economic success. The garment industry is exposed to increasing competition from Vietnam which has also developed upstream in the sector (see Box 1: Exports of Textile and Apparel Articles: *Cambodia is a strong competitor for Vietnam in the EU market*) together with emerging competition from Myanmar which is opening up to foreign investment. In addition, given potential negative impacts of the European Union-Vietnam Free Trade Agreement (EVFTA) and the Trans-Pacific Partnership (TPP) on Cambodia's garment exports, it will be important to devise a concrete plan to improve competitiveness and diversifying export sectors. Currently, there are significant risks of investment and export diversion away from Cambodia unless key constraints, such as high energy and transportation costs and infrastructure bottlenecks are successfully addressed. Structural reforms to make Cambodia's tradeable sector more competitive is core to improving competitiveness of the economy (see the Selected Issue on the Garment Sector in Perspective for a more detailed discussion).

Promoting local participation in the garment industry will be important including

encouraging more supporting industries to the garment sector from locally-owned small and medium-sized enterprises. Given the “footloose” characteristics of its garment industry together with the existing ownership structure whereby there are only a handful of domestic investors, garment factories can be relocated relatively quickly from Cambodia to more attractive countries, if they face a squeeze in profit margins due to rising input costs, higher taxes, less favorable preferential trade treatment, or an economic slowdown in key export markets. Promoting joint ventures and partnerships between domestic and foreign investors may also be a way forward.

Managing risks arising from the construction boom will be important for maintaining economic resilience.

While continued strong activity in the construction activity supports growth, risks associated with the construction boom are rising. Although the boom is not entirely financed by domestic credit, a sharp decline in the construction sector could cause major economic disruptions, negatively affecting growth and employment. Exposure of households to the existing real estate boom is likely to be substantial. Therefore, risks arising from the construction boom need to be promptly addressed and their negative impacts timely mitigated. Closely monitoring the construction sector in order to maintain macroeconomic stability is crucial. International experience shows policy options to contain a boom (before it reaches dangerous proportions) include monetary and fiscal tightening and macro-prudential measures (see a more detailed discussion in the construction sector section). Positive initial steps have been made to monitor and regulate the housing development by introducing a regulation called Prakas on Housing Development Management in August 2016.

Developing tourism further as growth engine.

Given untapped potentials as Cambodia is endowed with countless historical, cultural and natural destinations, the tourism sector can be revitalized so that it once again becomes a strong

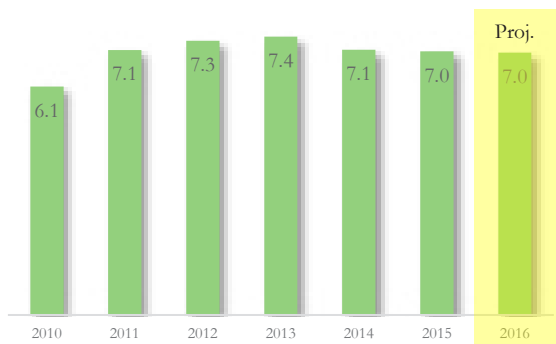
driver of growth. While positive initial steps have been made by establishing more connecting flights from Japan and other countries (and regions), introducing the “China Ready” initiative aimed at attracting 2 million Chinese visitors by 2020 and adopting “Two Kingdoms, One Destination”, a joint tourism initiative with Thailand with single visas, diversification of tourist attraction sites beyond the Angkor Wat complex appears necessary (see the Tourism Sector for a more detailed discussion).

Closing the human opportunities gap. Despite the reduction in extreme poverty, the share of non-poor but economically insecure households has been growing, with very limited mobility towards economic security since 2009. This is in part because of limited human capital or other assets such as land. The challenge for Cambodia, is to close gaps in human development and build the foundations for a middle-class society, while also investing in programs to promote the resilience of households and help minimize their vulnerability (see the Poverty Sector for a more detailed discussion).

THE CAMBODIAN ECONOMY AT A GLANCE

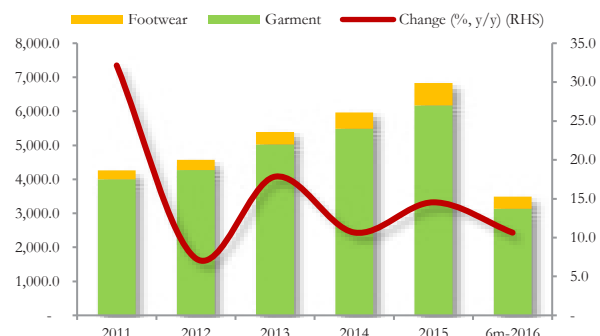
Cambodia's export-led growth continues ...

Robust growth continues, percent



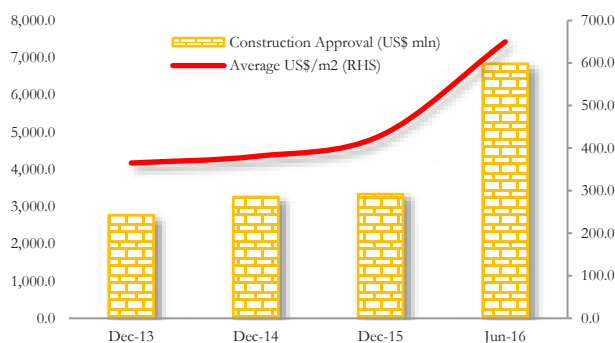
...driven by solid garment and footwear exports...

Garment and footwear exports continue to expand, US\$ million

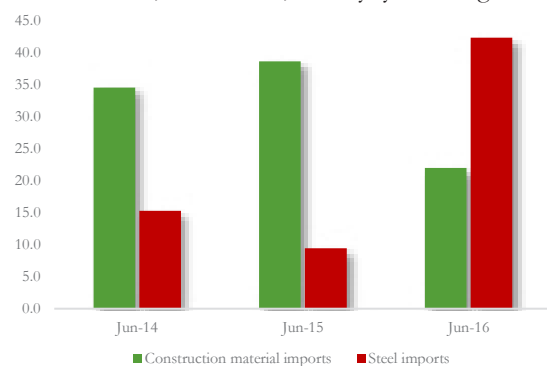


...and continued strong construction activity... ...witnessed by rising construction materials imports...

Construction permit approval continues to rise, US\$ million, YTD

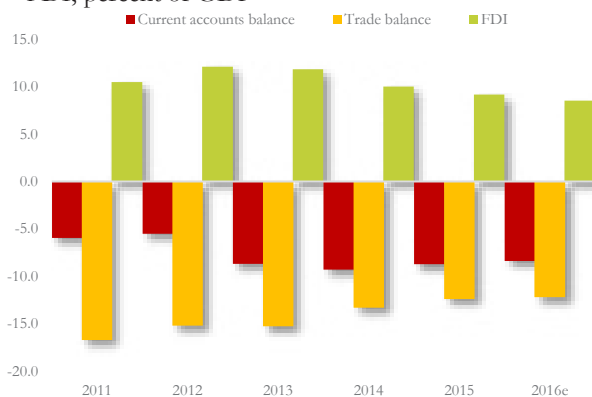


Strong construction equipment and steel imports continues, metric tons, YTD y/y % change



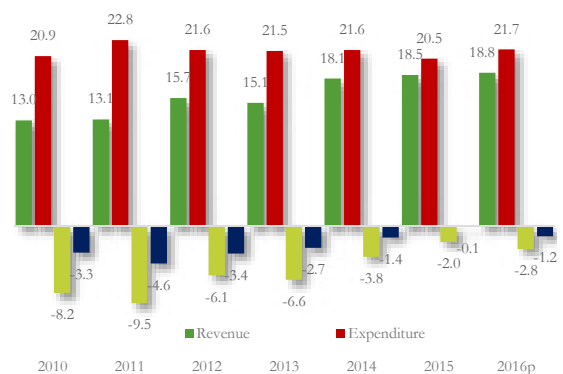
...while strong exports support the external position ...

Narrowing current account deficits financed largely by FDI, percent of GDP



...and good collection partly offsets impacts of the fiscal expansion.

After several years of fiscal consolidation, expansionary fiscal policy starts in 2016, percent of GDP



Recent Economic Developments

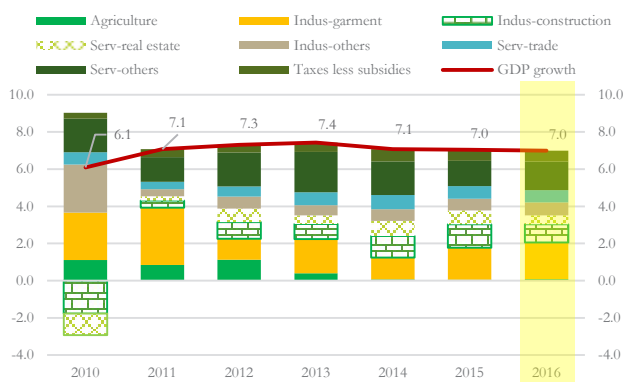
An overview

Strong growth has been underpinned by solid garment exports, construction and services.

As one of the main drivers of growth, the garment (and footwear) sector contributed a quarter of real growth in 2015 (Figure 1). Expansion of the construction sector has also continued, driven in part by foreign direct investment (FDI) inflows. Performance of the tourism sector was weaker than expected with the total tourist arrivals in the first of half 2016 rising by 2.6 percent year on year, compared with 4.6 percent during the same period last year. The agriculture sector is likely to improve marginally this year due to better weather conditions.

Real GDP growth is therefore expected to reach 7.0 percent in 2016, slightly higher than an earlier projection of 6.9 percent and similar to that of 2015.

Figure 1: Continued solid garment (and footwear) performance. Contribution to annual real growth, percent



Source: The Cambodia authorities and World Bank staff estimates.
e= estimate; p = projection.

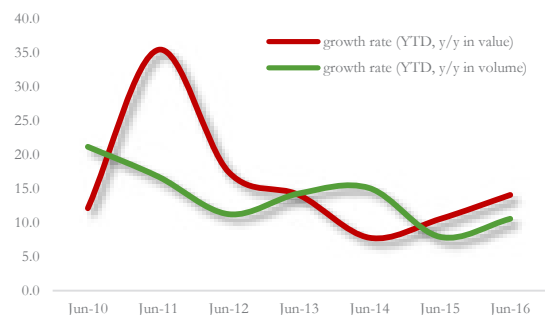
The real sector

a) Garments

¹ The Labor Advisory Committee was set up in 2006 under the Labor Law. For more detail, see http://www.cambodiainvestment.gov.kh/press-release-of-labor-advisory-committee-molvt-lac_061019.html

Garment exports maintained a high growth rate of 10.5 percent (in value terms) year-on-year by mid-2016, compared with 7.8 percent during the same period last year. This is underpinned by relatively stable industrial relations as the tripartite Labor Advisory Committee minimum wage has so far successfully handled wage negotiations¹ since 2014, underpinned by a recovery in the Euro area which is proceeding at a moderate pace, supported by an exceptional level of monetary policy accommodation, low oil prices and slightly expansionary fiscal policies² (Figure 2). Rising volume has continued to drive garment exports growth over the past four years, led largely by the exports to the EU market as Cambodia is currently enjoying “Everything But Arms” (EBA) preferential treatment under the EU’s Generalized Scheme of Preferences (GSP). See an analytical note on Cambodia’s garment sector in the selected issue section entitled “the Garment Sector in Perspective”.

Figure 2: Garment exports accelerated in the first half of 2016, YTD, year-on-year percent change



Source: The Cambodian authorities

During the first six months of 2016, garment exports to the EU market expanded by US\$248 million, contributing to 83 percent of the total exports value increase while garment exports to the US market declined by US\$114 million. Although Vietnam has already shifted its focus to higher value added products, it still competes with Cambodia for garment export market share and to attract FDI (see Box 1: Exports of Textile and Apparel Articles Cambodia is a strong competitor for Vietnam in the EU market). Note that unlike Cambodia, Vietnam does not receive “EBA”.

² Development economics - prospects, the World Bank (June 2016)

Box 1: Exports of Textile and Apparel Articles

Cambodia is a strong competitor for Vietnam in the EU market.¹

Textiles and textile articles (mainly apparel and clothing accessories) are an important source of merchandise exports for both Cambodia and Vietnam. At present, the shares of garment exports in total merchandise exports are about 70 and 16 percent for Cambodia and Vietnam, respectively (Figure B1). While Vietnam's share of garment exports is broadly stable, Cambodia's share appears relatively volatile, gradually declining prior to (and significantly shrinking during) the 2008-09 global financial crisis. The industry accounts for about one quarter of total employments for Cambodia and nearly 10 percent of employment in Vietnam's corporate sector.

The European Union (EU) market is the most important market for garment exports from Cambodia while the United States (US) is the largest market for Vietnam's garment exports. Both countries have successfully gained their market share in these markets over the years. Cambodia's share in EU garment imports rose rapidly from 0.7 percent in 2010 to 2.2 percent in 2015. During the same period, Vietnam increased its share in the US garment market from 7.0 percent to 10.6 percent (Figure B2).

Currently, Vietnam and Cambodia have similar shares in the EU market for imported apparel. However, Cambodia has an advantage relative to Vietnam in exporting knitted and crocheted apparel (HS code 61) to the EU market. While Vietnam's share of this apparel category in the EU market did not significantly change in 2010-15, Cambodia's share jumped significantly from 1.4 percent to 3.5 percent (Figure B3). In nominal terms, Cambodia exported about US\$2.0 billion in knitted and crocheted apparel to the EU in 2015—twice as much as Vietnam.

Despite the importance of the garment industry in job creation and income generation for lower-skill workers in both Cambodia and Vietnam, the activities of the industry in both countries are at the lowest end of the value chain; primarily consisting of CMT (Cut, Make, Trim). The CMT process uses mostly imported materials and accessories. Strategic development of supporting industries for the garment industries in both countries could be critical to gain further benefits. In addition, diversification of export markets would help the two countries to mitigate the negative impacts from fluctuations in external demand for key exports.

1/ Authored by Viet Tuan Dinh, Senior Economist, Vietnam Country Office and Sodeth Ly, Senior Economist, Cambodia Country Office, the World Bank Group.

Figure B1: Exports of Textile and Textile Articles
(Share of total merchandise exports)

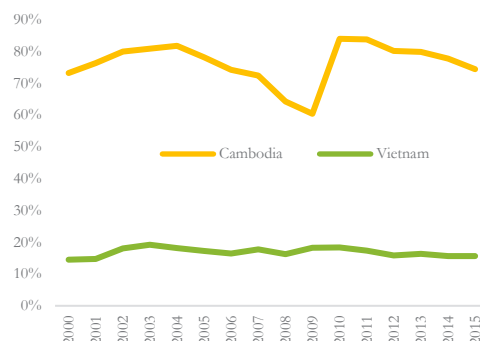


Figure B2: Exports of Textile and Textile Articles
(Share of the market, 2015)

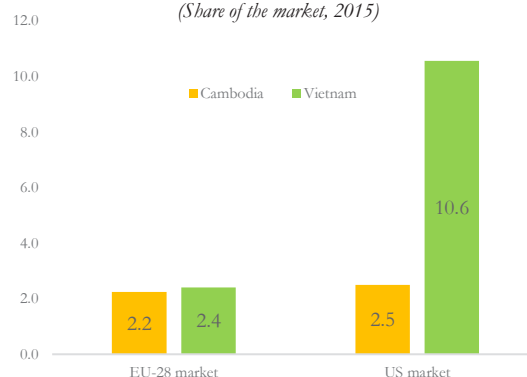
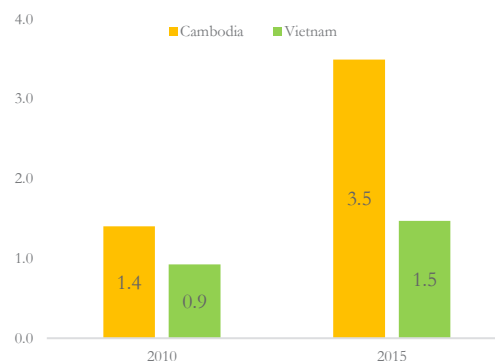


Figure B3: Share of EU-28 market, 2015
(Articles of apparel and clothing accessories, knitted or crocheted - HS 61)

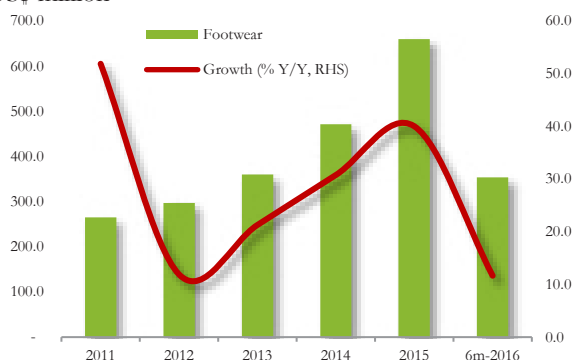


Source: National data, UN Comtrade and World Bank WITS

b) Footwear

The footwear sector is a promising export industry for Cambodia, largely destined for the EU market. In 2015, the EU market accounted for almost 50 percent of total footwear

Figure 3 : Rising exports of footwear continues, US\$ million



Source: The Cambodian authorities

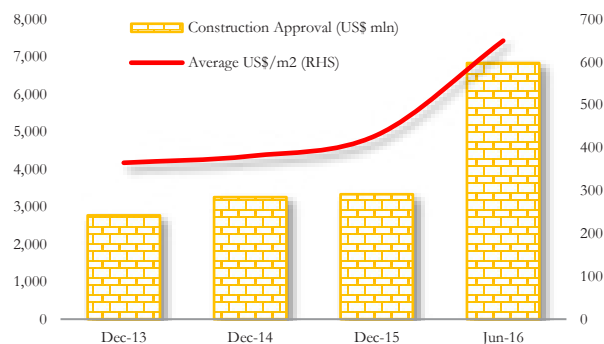
exports. The US and Japan markets captured 16 percent and 13 percent, respectively. Footwear exports grew by 11.6 percent year-on-year, reaching US\$353 million during the first six months of 2016 (Figure 3), compared with a 40 percent year-on-year jump in 2015. A low base effect appears to have contributed to high footwear exports growth rates in recent years.

c) Construction and real estate

In 2016, strong activity in the construction sector has continued; however, prolonged expansion of the construction sector has increased risks associated with the construction boom. The construction (and real estate) sector accounted for almost 30 percent of real growth in 2015 and is projected to remain the second most dynamic driver of growth after the garment sector. Imports of construction equipment and materials are rising. Imports of steel (in volume terms) remained high, at 42.4 percent year-on-year during the first half of 2016, reflecting continued strong activity (For more discussion on imports, refer to the external sector section). Investor appetite for construction and

real estate investment projects, especially in modern high-rise residential and commercial buildings, seems to have remained strong, as seen in an acceleration of construction project approval value, reaching US\$ 6.8 billion with 1,200 projects approved by mid-2016, compared with US\$ 3.3 billion with 2,000 projects for the entire year in 2015 (Figure 4).³ However, due to oversupply concerns, a few developers were reportedly forced to put their projects (or parts thereof) on hold, given that living in high-rise buildings remains relatively new experience for local population.⁴

Figure 4: High-end construction projects are expanding, as seen in the rising average cost per m², while the number of approved projects has surged



Source: The Cambodian authorities

Given the prolonged expansion of the construction and real estate sector, timely migrating the risks associated with the existing construction boom is highly recommended. During the period 2000-15, foreign investment in the construction sector amounts to US\$ 3.5 billion, accounting for 27.3 percent of the total registered investment value in the construction sector.⁵ South Korea appears to be the largest investor in the construction sector, accounting for about US\$1.6 billion or 44.6 percent of the total registered investment value during the period 2000-15 (Figure 5). South Korea's investment appears to focus on high-end construction projects, having the highest cost per square meter averaging US\$ 433.6/m² invested in

³ Lack of detailed construction project data does not allow for investigating whether there is (are) mega project(s) that prompted the surge. However, total number of projects increased.

⁴ "Developer puts condo project The Bay on hold as supply glut looms". *The Phnom Penh Post*, August 29, 2016.

⁵ Report on Foreign Direct Investment Survey 2014, July 2016, NBC

44 projects or 17 percent of total registered foreign funded construction projects. Chinese investment in the sector is next, amounting to

Box 2: Cambodia and Thailand: Tourism

Highlights

	Cambodia	Thailand
International arrivals (2015)	4.7 million	29.3 million
(year-on-year change)	6.1 percent	17.7 percent
Arrivals by air (% of total)	52.0 percent	34.3 percent
Largest market	Vietnam	China
(Number of visitors)	1 million	8 million
(% share)	20.7 percent	30.0 percent
Contribution to GDP	16.0 percent	19.3 percent
(Rank)	74th	14th
Direct employments ('000)	985.4	2,210.2
(Rank)	17th	8th
(% of total employments)	11.9 percent	5.8 percent
Expense by tourist a day	US\$ 94.0	US\$ 149.4
Average stay	6.5 days	10.0 days

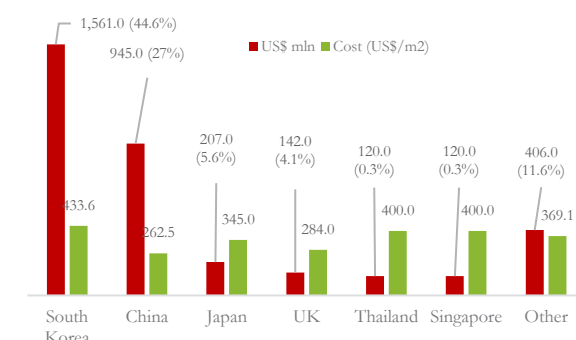
Source: World Travel and Tourism Council (2015), Department of Tourism, Ministry of Tourism. See <https://www.wttc.org/-/media/files/reports/economic%20impact%20research/countries%202015/thailand2015.pdf> for more details.

almost US\$1 billion or 27 percent of the total registered foreign funded investment value. However, China seems to invest mainly in low-end construction projects, having the lowest cost per square meter, averaging US\$ 262.5/m² with the largest number of 94 projects or 37 percent of total projects.

The construction and real estate sector needs to be closely monitored in order to maintain macroeconomic stability and international experience shows policy options to contain a boom before it reaches dangerous proportions include both monetary and fiscal tightening such as property taxes and transaction and capital gain taxes, and macro-prudential measures such as differentiated capital requirements for real estate loans and higher risk weights on real estate loans.⁶

⁶ How to Deal with Real Estate Booms: Lessons from Country Experiences, IMF working paper (2011).

Figure 5: South Korea is the largest investor in the construction sector investing in high-end projects. Foreign investment in the construction sector by country (2000-15)



Source: The Cambodian authorities

Positive initial steps have been made to monitor and regulate housing development activity by introducing a regulation called Prakas on Housing Development Management in August 2016.⁷ The regulation aims at improving the management of the housing market by closely monitoring housing development activity while also improving its transparency. Housing development projects must now follow licensing requirement processes that will allow the regulators to strengthen their ability to better monitor and manage property market developments, to protect consumers and to prevent money laundering activity.

d) Tourism

Table 1: Arrivals to Cambodia eased by mid-2016 while arrivals to Thailand decelerated, million

	Cambodia			Thailand		
	2014	2015	6m 2016	2014	2015	6m 2016
Total arrival	4.5	4.8	2.4	24.8	29.3	16.6
Change (y/y, %)	6.9%	6.1%	2.6%	-6.4%	17.7%	12.1%
o/w Air arrival	2.3	2.5	1.3	15.5	18.4	13.6
Change (y/y, %)	12.7%	8.9%	6.0%	1.0%	18.6%	47.6%

Source: The Cambodian authorities and the Tourism Authority of Thailand

While continuing to grow, international arrivals decelerated in the first half of 2016. Total tourist arrivals in first of half 2016 eased to

⁷ See the Prakas No.965 MEF Brk dated 24 August 2016 for more details.

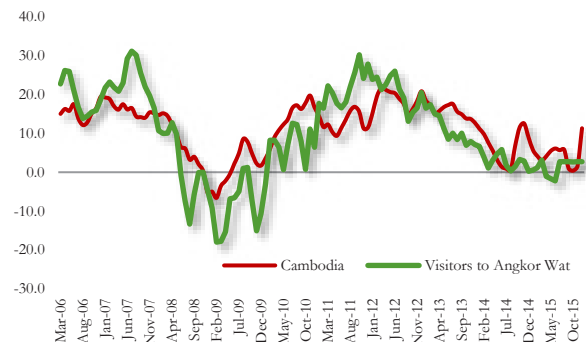
a 2.6 percent year-on-year increase (Table 1). This is compared with a 4.6 percent increase during the same period last year. While arrivals by air held up rather well, growing at 6.0 percent year-on-year by mid-2016, compared with 8.2 percent during the same period last year, arrivals by land (and waterways) were disappointing, declining by 1.4 percent, compared with a 0.6 percent year-on-year increase. The initial strong recovery in regional tourism activity, in particular tourist arrivals to Thailand, was short-lived and its positive impact earlier anticipated on the tourism sector in Cambodia failed to materialize. It is important to note the dependency of Cambodia's relatively new tourism sector on Thailand's more developed tourism sector remains (see Box 2: Cambodia and Thailand: Tourism for highlights of the tourism sector in the two countries).

Diversification of tourist attraction sites beyond the Angkor Wat complex may be necessary to restore strong arrivals growth that Cambodia had witnessed until 2013. Unlike Thailand, where 80 percent of tourists prefer sea-sun-sand and nature-based destinations, arrivals to Cambodia continue to be largely attracted by the Angkor Wat complex (Figure 6) although the country is endowed with countless historical, cultural and natural destinations. Tourist destination diversification will help improve Cambodia's tourist return rate which currently stands at about 16 percent, compared with over 50 percent for Thailand and further broaden the domestic market base, encouraging additional investments in the services sector such as travel services, telecommunications and transports, hospitality and more.

Arrivals from Vietnam and China continue to be ranked first and second, commanding 19.6 percent and 16.0 percent of the total arrivals, respectively. South Korea (replacing Lao PDR) became the third largest market, accounting for 8.2 percent of the total by mid-2016 while Thailand was ranked fourth. Asia continues to be the major source of tourists and arrivals from the top four markets (Vietnam, China, South Korea

and Lao PDR) accounted for 51 percent of the total during the first six months of 2016.

Figure 6: International arrivals remain largely attracted by Angkor Wat (and negatively affected by the 2008-09 global financial crisis). Arrivals and visitors to Angkor Wat, 3mma, year-on-year percent change



Source: The Cambodian authorities

The countries comprising Cambodia's top ten tourist markets remain almost unchanged over the past several years. However, dynamics within the top ten countries have shifted toward continued rising arrivals from China while visitors from South Korea and Lao PDR have been on the decline since 2014 although their large shares remain. A recent initiative, the "China Ready", focusing on attracting more Chinese visitors introduced by the authorities appears to exactly take advantage of the shift.

Efforts have been made by the authorities to revitalize the sector by establishing more connecting flights from Japan and other countries (regions), the "China Ready" initiative aiming at attracting 2 million Chinese visitors by 2020 and "Two Kingdoms, One Destination", a joint tourism initiative with Thailand with single visas. Tourist products in Cambodia also remain to be diversified. Appreciation of the US dollar has also made tourists' trips to Cambodia more expensive.

e) Agriculture

The performance of the agriculture sector is likely to improve marginally this year due to better weather conditions. While improvements in production and yield remain to be seen, the cultivation of rice crops -- which account for 60 percent of the agriculture sector's value addition

in the gross domestic product -- expanded by 13.5 percent during the first eight months of this year, compared with the same period last year (Table 2) due to modest rainfall. Cultivation of cassava, corn and vegetable also witnessed progress during the same period.

Table 2: Agriculture cultivation has expanded due to relatively favorable weather conditions this year

Agricultural production (planted area, 000' ha)	8m-2015	8m-2016	Change (%)
Rice	1,988.39	2,256.58	13.5
Cassava	541.28	627.88	16.0
Corn	53.88	69.03	28.1
Vegetable	23.69	25.29	6.7
Bean	37.59	32.32	-14.0

Source: The Cambodian authorities, <http://www.maff.gov.kh/reports/69-croppingstatus/1558-weekly-report-17-08-16.html>

During 2004-12, agricultural growth was impressive, averaging 6.0 percent (at constant prices). During the same period, Cambodia's rice yield rose by almost two-thirds, reaching 3.1 metric tons per hectare in 2012 from 1.9 metric tons per hectare in 2002. However, during 2013-15, agricultural growth slowed significantly, averaging 0.2 percent due largely to stagnant yield as the country confronted less favorable conditions and constraints on expansion of cultivated areas.

Table 3: Cambodia's average rice yield remains low compared with those of regional countries, average rice yield 2010-13, metric tons per ha

Country	Paddy rice	Cassava	Maize
<i>Cambodia</i>	<i>3.0</i>	<i>22.0</i>	<i>4.1</i>
Thailand	3.0	20.5	4.3
Vietnam	5.5	17.7	4.3
Indonesia	5.0	21.1	4.7
Philippines	3.8	10.2	2.3

Source: Cambodian agriculture in transition: opportunities and risks, the World Bank (2015)

Cambodia's average rice yield (and other crops' yields) remains lower than those of regional countries, with the sole exception of Thailand (Table 3).

In 2015, despite depressed prices, production of the main agricultural products such as rubber and cassava continued to improve.

Rubber production rose to 126,800 metric tons or 30.7 percent year-on-year increase in 2015 while cassava production increased to 12.5 million metric tons or a 4.6 percent year-on-year increase (see also the discussion on agricultural product exports in the external sector section).⁸ Production of sugarcane, however, declined to 0.6 million metric tons or a 57.7 percent year-on-year decrease.

Initial efforts have been made to revitalize the agriculture sector supported by all stakeholders, namely the public sector, the private sector, development partners and agricultural research and training institutions.

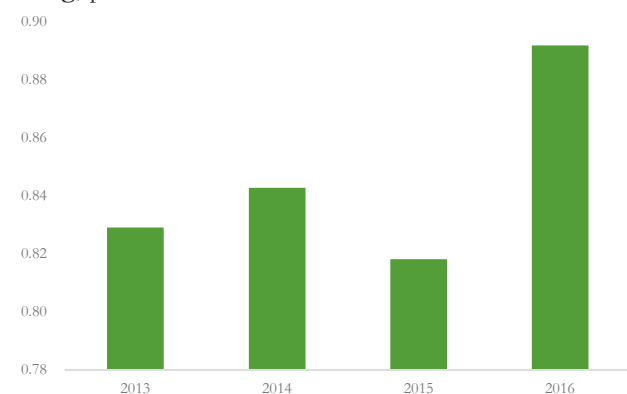
To ensure the appropriate targeting of public programs and support to the agriculture sector, consultation workshops are held regularly and are widely attended. In addition, in recent years, budget appropriation to the Ministry of Agriculture, Forestry and Fisheries (MAFF), the Ministry of Water Resources and Meteorology (MoRAM) and the Ministry of Rural Development (MRD) that directly supports the agriculture sector has been gradually increased (Figure 7). In 2015, the World Bank produced a report entitled "*Cambodian Agriculture in Transition: Opportunities and Risks*"⁹ suggesting the revitalization of the agriculture sector based on four sets of policies: (i) maintaining a private-sector-friendly agriculture policy environment with additional attention to lower the regulatory burden in farm input sectors; (ii) strengthening environmental sustainability of agriculture production; (iii) improving the quality of agriculture programs while increasing allocations

⁸ Annual report, Ministry of Agriculture, Forestry and Fisheries, 2015 achievements and 2016 targets.

⁹ The full report can be accessed at <http://documents.worldbank.org/curated/en/2015/08/24919384/cambodian-agriculture-transition-opportunities-risks>.

to more effective programs; and (iv) developing the agribusiness and agro-processing industry.

Figure 7: Combined (domestically financed) budget for the three ministries, MAFF, MRD, and MoRAM directly engage in the agriculture sector is gradually rising, percent of GDP



Source: the Cambodian authorities

Poverty

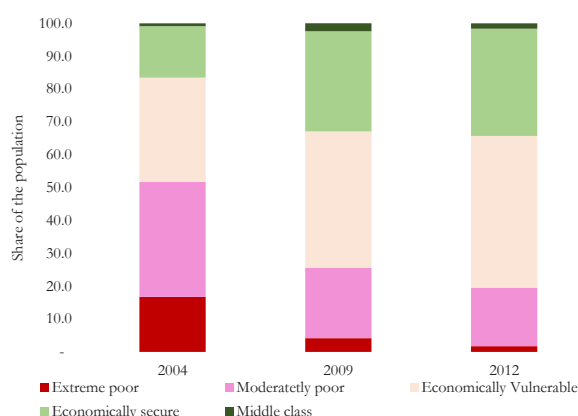
Cambodia has recently been reclassified as a lower-middle-income economy by the World Bank Group (WBG). Published by the WBG on July 1, 2016, Cambodia's GNI per capita for 2015 was US\$1,070, above the threshold for the low-income group, set at \$1,025 for the World Bank's 2017 fiscal year.

Over the past decade, Cambodia has attained dramatic gains in terms of poverty reduction, driven by higher agricultural prices, the expansion of land under cultivation and increases in yields. Rural households reaped the benefits of growth in the agriculture sector, while in recent years, urban households have benefitted from expansion of the garment and construction sectors. As discussed in the agriculture sector section above, confronted with less favorable weather conditions, growth has slowed recently. And this year, although the weather conditions are slightly better, the ongoing 2015-16 El Nino event which has caused severe droughts in most parts of the country continues to be a challenge for poverty reduction.

Nonetheless, the downward trend in poverty is expected to continue over the next few years but driven by different factors than

previously. Poverty reduction in Cambodia has been resilient to various economic shocks in the

Figure 8: Despite the reduction in extreme poverty, the share of non-poor but economically insecure households has been growing



Source: World Bank staff estimates

past. Further reductions in poverty are thus expected for both urban and rural households throughout 2015-16 but with a different set of drivers than previously. For urban households poverty reduction will be driven by growth in the construction, garment and services sectors. For rural households there has been an increase in sources of non-agriculture income. Agriculture now constitutes only 25 percent of income of the bottom 40 percent in rural areas and this diversification has cushioned households from the impact of declining food prices. However, the decline in food prices will still deprive households a previous source of income growth. Thus, the pace of poverty reduction is likely to be slower than in previous years.

Despite the reduction in extreme poverty, the share of non-poor but economically insecure households has been growing, with very limited mobility towards economic security since 2009, in part because of limited human capital or other assets such as land (Figure 8). The challenge for Cambodia will therefore be to close gaps in human development which remain large (Table 4), and build the foundations for a middle-class society, while also investing in programs that promote resilience of households and to help minimize their vulnerability.

Table 4: Cambodia's large gaps in human development remain

	KHM	LAO	VNM	LMC
Education (2013)				
Lower secondary completion rate, total (% of relevant age group)	43.6	48.9	77.4	71.2
Primary completion rate, total (% of relevant age group)	93.9	98.8	99.2	91.2
Health (2015)				
Mortality rate, infant (per 1,000 live births)	24.6	50.7	17.3	40.0
Mortality rate, under-5 (per 1,000 live births)	28.7	66.7	21.7	52.8
Basic Services (2015)				
Improved sanitation facilities (% of population with access)	42.4	70.9	78.0	52.0
Improved water source (% of population with access)	75.5	75.7	97.6	89.5
Access to electricity (% of population, 2012)	31.1	70.0	99.0	78.0

Note: KHM: Cambodia; LAO: Lao PDR, VNM: Vietnam; and LMC: Lower middle-income economy
Source: WDI (2016)

The external sector

Cambodia's external position improved further with a continued solid export performance and sluggish oil prices. The current account deficit (excluding official transfers) is projected to narrow to 10.2 percent of GDP in 2016, compared with 10.6 percent in 2015, mainly financed by FDI. FDI is expected to reach US\$1.7 billion or 8.5 percent of GDP in 2016, similar to US\$1.6 billion in 2015 or 9.1 percent of GDP (Figure 9). The slightly easing FDI inflows as a percentage of GDP could be partly explained by increasing regional competition and perhaps also by the postponement of investment decisions until after the elections. However, rapid gross international reserves accumulation continued, reaching US\$6.4 billion (or 5.4 months of imports) by mid-2016, compared with US\$5.6 billion in 2015.¹⁰

a) Merchandise exports

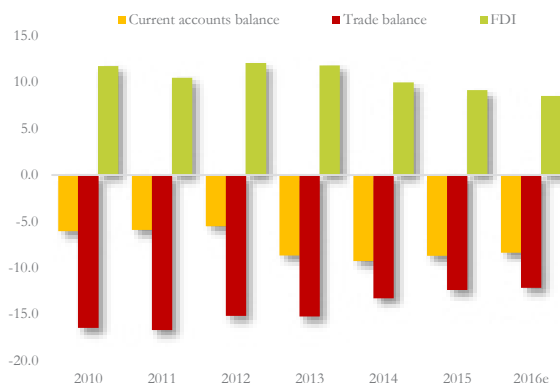
The solid export performance has helped narrow the current account deficit.

¹⁰ Includes Chinese Yuan

¹¹ About 20 percent of paddy rice is milled and exported as milled rice (the balance of 80 percent of rice surplus is exported in the form of paddy).

Growth in total merchandise exports is expected to remain strong, at 10 percent year-on-year in 2016, compared with 10.8 percent in 2015, contributing to the narrowing of the current

Figure 9: FDI largely finances current account deficits which are narrowing, percent of GDP



Source: The Cambodian authorities and Bank staff estimates

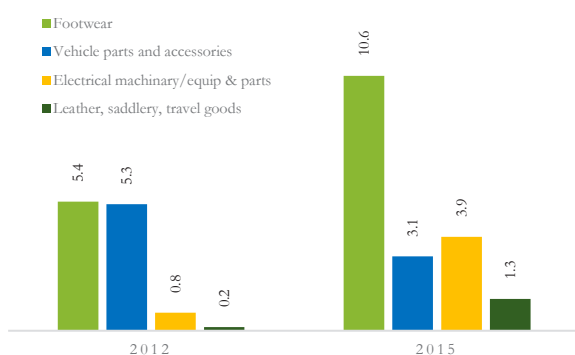
account deficit. This is underpinned by the robust performance of garment (and footwear) exports which account for about 80 percent of the total. Despite the appreciation of the US dollar, garment and footwear exports are expanding due largely to the return of stable industrial relations and recovery in the Euro area (see also the discussions on this in the Selected Issue on The Garment Sector in Perspective).

Prolonged low agricultural commodity prices have partly thwarted an otherwise successful effort in agricultural export diversification toward higher value added agricultural products, namely rubber, cassava, sugarcane and other crops (other than rice) that potentially broaden agro-processing industries well beyond rice milling and processing. Exports of these agricultural commodity products remained sluggish during the first six months of 2016. Rubber exports have been hardest hit with year-on-year export value declining by 30.4 percent while exports of milled rice fell by 9 percent year-on-year, compared with 50 percent increase in 2015, achieving only US\$147 million by mid-2016.¹¹

Milled rice exports account for 30 percent of total rice export earnings (US\$722 million in 2014). Paddy rice and cassava exports are not recorded.

Progress on manufactured product exports diversification continues. In addition to footwear exports which have been rapidly growing, a range of new and more sophisticated manufactured products, notably vehicle parts and accessories including bicycles, electronic machinery equipment parts and articles of leather, travel goods and handbags have emerged (Figure 10).

Figure 10: Diversification beyond garment has started, led by footwear, bicycle, vehicle parts, electrical machinery/equip parts, and leather and travel goods, percent of goods exports



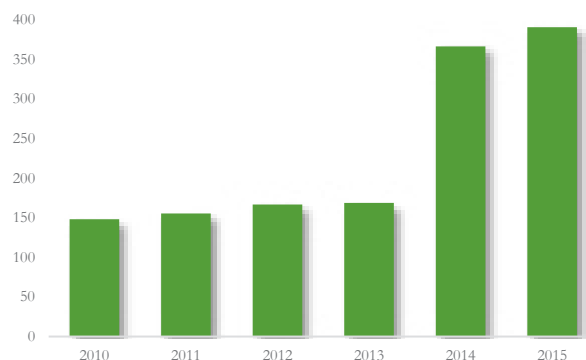
Source: UN COMTRADE

b) Services and transfers receipts

Services receipts come in second, after merchandise exports, accounting for 15 percent of GDP. Vibrant travel and international trade activity fueled by strong household and government consumption has continued to boost services receipts. Of the total services receipts, 80 percent is projected to be generated by travel services in 2016.

For transfers receipts, remittances are estimated to account for about US\$400 million in 2015 (Figure 11). This corresponds to the large number of Cambodian migrant workers who are now employed in the neighboring countries, particularly in Thailand. The remittances are likely to remain strong this year.

Figure 11: Workers' remittance increase in 2014-15, reflecting the large number of migrant workers employed outside Cambodia, US\$ million

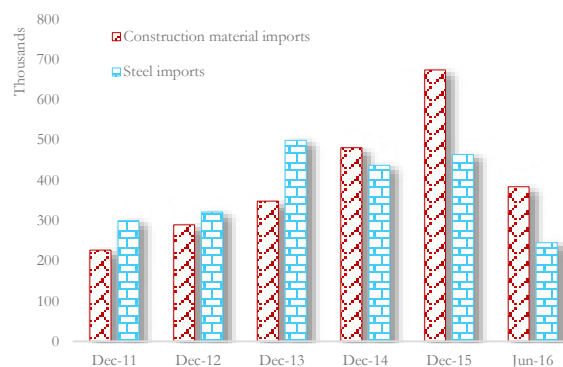


Source: The Cambodian authorities

c) Merchandise imports

Growth in merchandise imports accelerated to 9.6 percent year-on-year from 8.4 percent in 2015, fueled by strong domestic demand for construction and consumption, although import substitution industries especially beverage, sugar, tobacco and cement industries are rapidly emerging. As discussed in the construction sector section above, the ongoing construction boom continues to fuel construction equipment and steel imports (Figure 12).

Figure 12: The volume of construction equipments and steel imports is rising as a result of the ongoing construction boom, metric tons, YTD

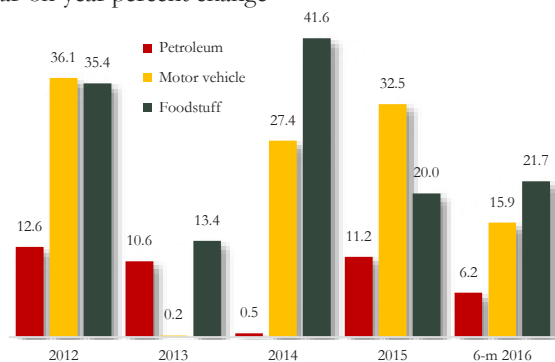


Source: The Cambodian authorities

Similarly, imports of key consumption goods such as vehicles, electronics, and foodstuff remain buoyant while petroleum products

imports are slowly rising because of continued depressed oil prices (Figure 13).¹²

Figure 13: Imports of consumption goods are rising, year-on-year percent change



Source: The Cambodian authorities

d) Foreign direct investment

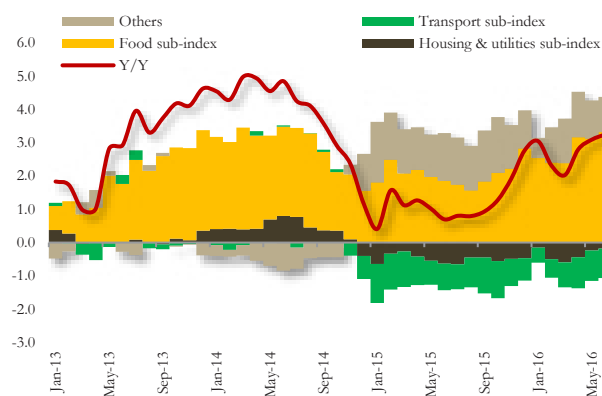
Over the past decade, Cambodia has been successful in attracting FDI inflows. Asia contributed almost 90 percent of the total FDI Cambodia received up to 2014.¹³ Chinese FDI accounted for the largest sum, at US\$8.4 billion or 44 percent of the total US\$19.2 billion in FDI stock by end-2014, concentrated in manufacturing, in particular the garment, accommodation and entertainment sectors (see the Selected Issue on the Garment Sector in Perspective for more details on Chinese FDI).¹⁴ South Korean FDI was ranked second, accounting for US\$2.8 billion or 15 percent of the total FDI stock, invested mainly in the construction and real estate sector. Vietnamese FDI, which is concentrated in agriculture and ICT was ranked third, accounting for 8 percent of the total FDI stock, followed by Malaysia, Thailand, Singapore and Japan in descending order of size.

Inflation

Rising food prices are building up inflationary pressures. As a result, the consumer price index (CPI) rose 3.0 percent year-on-year by July 2016,

compared with 2.8 percent by end-2015, largely due to rising food prices, in particular meat, fish and fruits fueled by strong domestic demand (Figure 14). Low oil prices, however, have helped subdue other CPI sub-indices such as housing, utilities and transport which remain largely in negative territory.

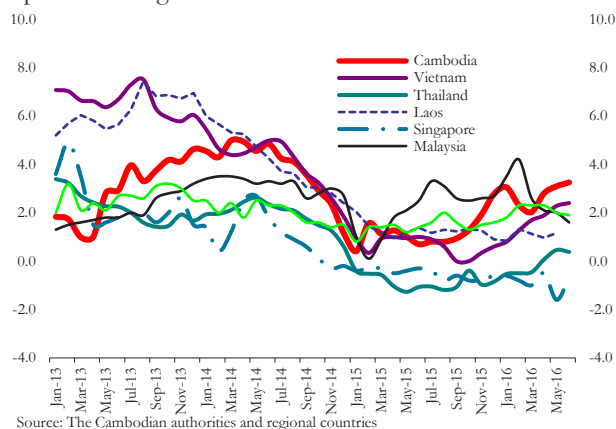
Figure 14: Inflation has edged up due to rising prices of food and other components (restaurant, health, furnishings, and clothing) of CPI basket. Contributions to 12-m inflation, percentage point



Source: The Cambodian authorities

Inflation has also edged up across the region. Cambodia's CPI, while remaining in low single digits, edged up fastest during the first six months of 2016, while regional inflation also rose.

Figure 15: Cambodia CPI rose fastest lately while regional inflation has also edged up, year-on-year percent change



Source: The Cambodian authorities and regional countries

Most of regional countries' inflation rates are now in positive territory (Figure 15), ending

¹² Another major imported item is the fabric used in the production of garments that are almost entirely for export.

¹³ Report on FDI Survey 2014, NBC and NIS

¹⁴ China, together with Hong Kong SAR, China; Macau SAR, China; and Taiwan, China.

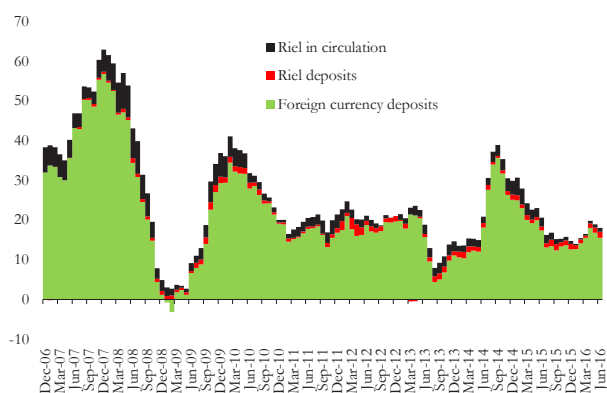
deflationary pressures, notwithstanding continuing depressed international oil and food prices.

The monetary sector

a) Monetary aggregates, interest rates and exchange rates

Improved confidence in the banking system appears to have supported the expansion of foreign currency deposits. Broad money growth picked up during the first half of 2016, accelerating to 18.0 percent year-on-year by mid-

Figure 16: Broad money growth stabilized as foreign currency deposits recovered. Contribution to broad money growth, year-on-year percent change



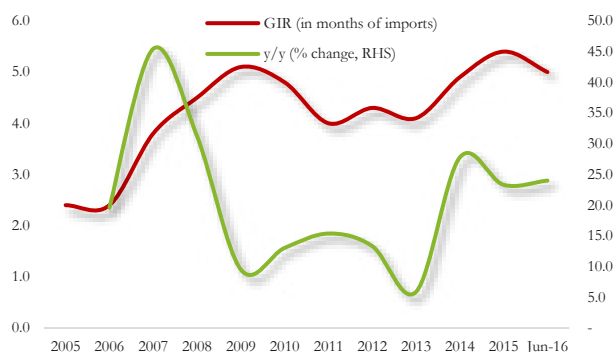
Source: The Cambodian authorities

2016, compared with 14.7 percent in 2015 (Figure 16). The contribution from foreign current deposits, which is responsible for most broad money growth, accounted for 15.5 percentage points by mid-2016, up from 12.6 percentage points in 2015. Contributions by riel deposits and riel in circulation are 1.6 percentage points and 1.0 percentage point, respectively. The subdued contribution by riel deposits and riel in circulation to broad money growth reflects persistently high dollarization of the Cambodian economy.

Net foreign assets of the central bank continue to rise with rapid gross foreign reserves accumulation, growing at 24 percent year-on-year, reaching US\$ 6.4 billion by June

2016, compared with US\$5.6 billion by end-2015 (Figure 17).¹⁵ This amount is equivalent 5.4

Figure 17: GIR growth and (prospective) import coverage of GIR have been rising since 2013



Source: World Bank staff estimates

months of prospective imports.

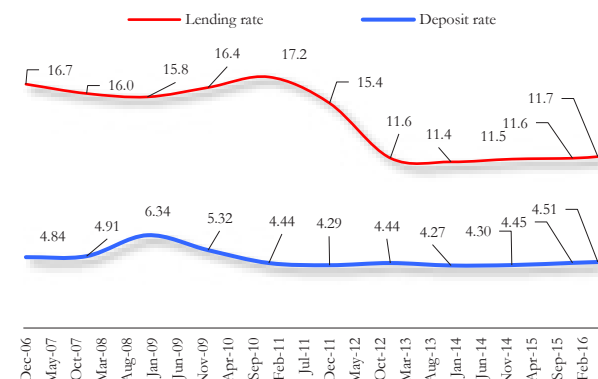
Strong demand for US dollar denominated credit may have exerted some pressures on lending (and deposit) interest rates, which have been edging up since May 2015 (Figure 18). The weighted average of 12-month US dollar deposit rates increased to 4.52 percent by mid-2016, up from 4.45 percent in 2015, while the 12-month US dollar lending rate also rose to 11.74 percent, from 11.60 percent in the same period. The interest rate spread—the difference between the nominal lending and deposit rates—widened to 7.22 percent by mid-2016 from 7.16 in June 2015 as the lending rate hike was more than offset by the deposit rate increase. With its highly dollarized economy and one-third of its exports going to the US, Cambodia seems to be influenced by US monetary policy and the US business cycle.

The central bank continues to maintain a broadly stable Cambodian riel versus US dollar exchange rate to obtain overall price stability. The riel, however, depreciated slightly, reaching CR 4,084 per US dollar in June 2016, compared with CR 4,050 per US dollar in December 2015. Similarly, depreciation of the riel against the Thai baht (and the Vietnamese dong) occurred, reaching CR 117.8 per baht in June

¹⁵ Includes Chinese Yuan.

2016, compared with CR 114.3 per baht in December 2015 (Figure 19).

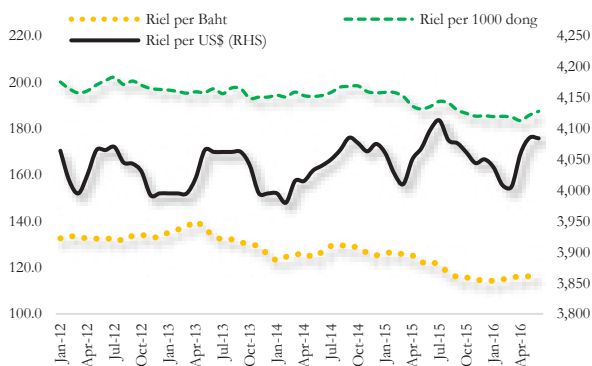
Figure 18: 12-month weighted average dollar deposit and lending rates have edged up, percent per annum



Source: The Cambodian authorities

Cambodia's effective exchange rates experienced depreciation towards mid-2016, indicating that Cambodia's external competitiveness may have improved slightly.¹⁶ The nominal effective exchange rate (NEER) and the real effective exchange rate (REER) have recently depreciated.¹⁷ The NEER index (2010=100) declined to 110.55 in June 2016 from 113.1 in December 2015 while the REER

Figure 19: The riel has now depreciated against the US dollar, baht and dong



Source: the Cambodian authorities, Bank of Thailand, and Vietnam statistics office.

index (2010=100) fell to 119.58 from 122.3 during

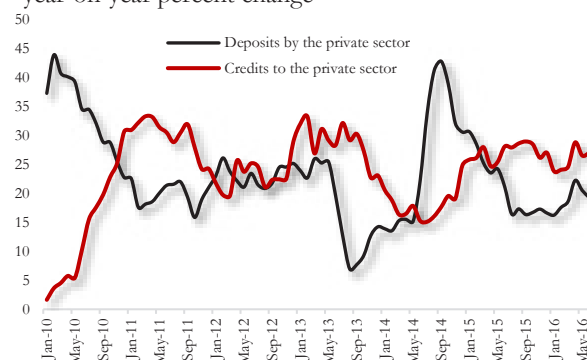
¹⁶ As the economy is highly dollarized, Cambodian Riel versus US dollar exchange rate loses most of its original meaning. The exchange rate only has meaning within the territory where riel is circulated.

¹⁷ REER is the nominal effective exchange rate (a measure of the value of a currency against a weighted average of several foreign currencies) divided by a price deflator or index of costs. See <http://datahelp.imf.org/knowledgebase/articles/537472-what-is-real-effective-exchange-rate-reer>

the same period. The depreciation should help underpin the balance of payments and growth.

b) The banking sector

Figure 20: Banking sector's high credit growth has continued while deposits growth picked up recently. Credits to and deposits by the private sector, year-on-year percent change



Source: The Cambodian authorities

Continued financial deepening has supported economic expansion. Although there are signs of slowing, in particular in the micro-finance sector, the banking sector's credit growth remained high, at 26.9 percent year-on-year, or US\$11.2 billion, by mid-2016, compared with 27.0 percent in 2015 (Figure 20).¹⁸ In contrast, growth of private sector deposits has picked up as confidence in the banking sector improved, reaching to 19.3 percent year-on-year by mid-2016, compared with 16.6 percent in 2015. As the initial recovery in deposit growth is more than offset by continued elevated credit growth, the loan-to-deposit ratio rose, reaching 97.0 percent by mid-2016. The non-performing loan (NPL) ratio improved slightly to 1.99 percent by end-2015 up from 2.22 percent at end-2014.¹⁹ It is important to note, however, that repayment rates generally look good in high-growth environments with about 30 percent year-on-year loan growth

¹⁸ If excluding (additional) credit by a new commercial bank which just was upgraded from micro-finance institution in April 2016, the banking sector's credit growth would have dropped to 20.2 percent year-on-year (instead of 28.8 percent).

¹⁹ Annual report, General Directorate of Banking Supervision, National Bank of Cambodia (2015).

rates because the denominator (total loans outstanding) often grows faster than NPLs.

Domestic credit has continued to contribute, at least partly, to the ongoing construction boom. The share of domestic credit provided to the construction, real estate and mortgage segments increased further, reaching 21 percent

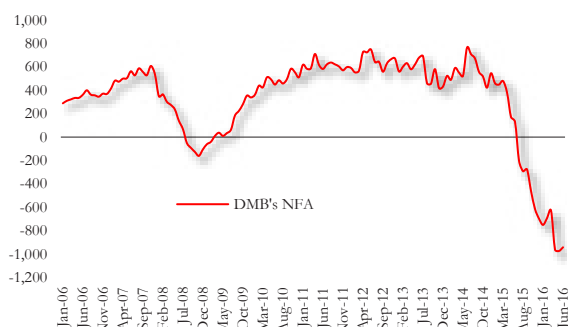
Figure 21: Loans and mortgages to the construction sector rose further in 2015, percent of total



Source: The Cambodian authorities

of total domestic credit by mid-2015 or US\$2.6 billion, compared with 20 percent or US\$2.2 billion in 2015 (Figure 21). The share is close to the peak of 23 percent in 2008, in the run-up to the global financial crisis when the housing bubble in Phnom Penh eventually burst.

Figure 22: DMBs' NFAs declined as the rise in foreign liabilities more than offset the increase in foreign assets, US\$ million



Note: NFAs: net foreign assets, DMBs: deposit money banks
Source: The Cambodian authorities

Previous real estate boom-bust cycles have had limited impact on households and the banking sector because the construction and real estate sector was largely foreign financed while the economy was mainly cash-based.

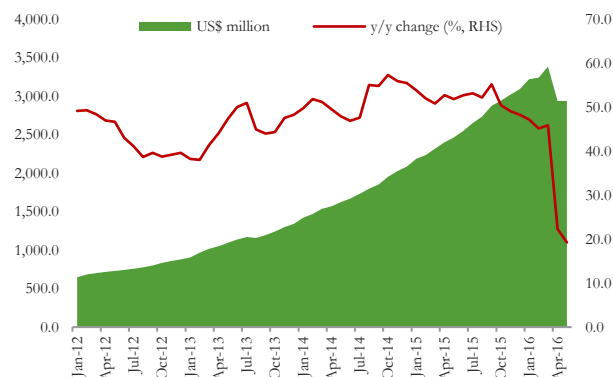
The expansion of the banking sector has continued to squeeze banks' net foreign assets. Banks' net foreign assets declined as the rise in foreign liabilities more than offset the increase in foreign assets (Figure 22).

In view of this, the central bank has introduced a higher reserve requirement of 12.5 percent for foreign borrowing together with a number of macro-prudential measures, namely doubling banks' capital requirements and raising the liquidity coverage ratio. Nonetheless, it will also be important to enhance supervision, coordination and the quality of information.

c) Microfinance

MFI credit growth declined to 19.3 percent year-on-year in May 2016 with outstanding credit of US\$2.9 billion, down from 48.3 percent in December 2015 with outstanding credit of US\$3.0 billion (Figure 23). Microfinance institutions (MFIs), which have played an important role in providing access to finance for the rural population, had experienced much faster credit growth than the banking sector until recently (see April 2016 Cambodia Economic Update for a more in-depth discussion of MFIs). However, an apparently sharp deceleration in MFI

Figure 23: With the graduation of one institution, credits provided by MFI decelerated by mid 2016



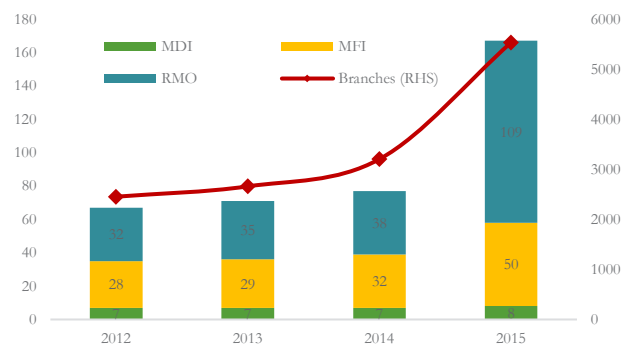
Source: The Cambodian authorities

credit growth, from 45.9 percent year-on-year in March 2016 to 22.3 percent in April 2016 was caused by the fact that an MFI was upgraded to commercial bank status (and its credit was then

recorded in that of commercial banks). After April 2016, a further decline in MFI credit growth has also occurred and reasons behind this decline are still unclear. Some initial analysis, however, attributes the decline to lower demand for financing due to slower business activity caused by continued depressed agricultural products in the rural areas as well as some difficulties in exporting the products to Cambodia's neighbors.

There has been a rapid increase in the number of MFIs and MFI branches. In 2015, there were 167 MFIs and registered micro-finance operators (RMOs) with a total of 5,533 branches. Of these eight were microfinance-deposit-taking institutions (MDIs), 50 MFIs and 109 RMOs (Figure 24).²⁰ During the same period, the microfinance sector witnessed a rapid increase in the number of borrowers to 2.037 million, up 14.8 percent and an increase in average loan size to about US\$1,500 up 30 percent on 2014's. The NPL ratio of MFIs was 0.77 percent in 2015, lower than the NPL ratio of 1.99 percent in the

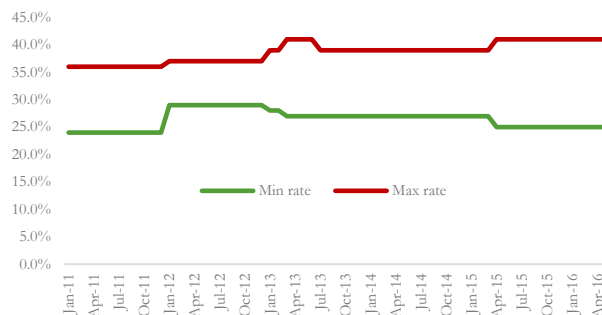
Figure 24: There was a surge in the number of microfinance institutions and their branches in 2015



Source: The Cambodian authorities
MDI: Microfinance institution; MDI: Microfinance deposit-taking institution; RMO: Registered microfinance operators.

banking sector. MFIs register an average return on equity of 22 percent.

Figure 25: Despite an increasing number of MFIs interest rates remain high while market segmentation has deepened as competition among MFIs heats up, percent per annum



Source: the Cambodian authorities

Interest rates charged by MFIs remain high, given the non-existence of currency risk as they borrow and lend in US dollars. This reflects inefficiency in the MFI sector. In addition, the difference between minimum interest rates and maximum rates has widened since April 2015, which may reflect deeper penetration by the sector with increased market segmentation (Figure 25) as competition heats up. As a result, loan quality has deteriorated with the rising NPL ratio to 0.77 percent in 2015, up from 0.59 percent in 2014.²¹ As loan growth declines or becomes negative, the NPL ratio will likely start to rise.

The fiscal sector

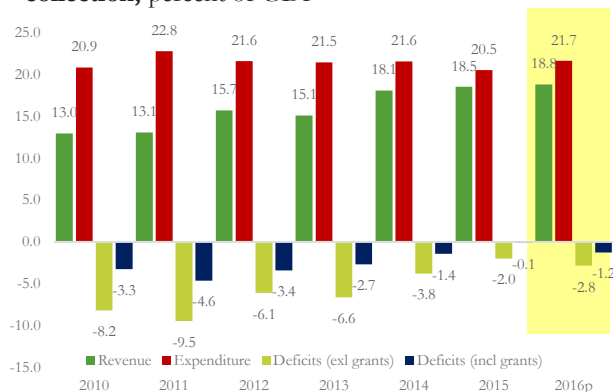
After several years of fiscal consolidation, fiscal policy became expansionary in 2016 while strong collection has continued. In 2016, public outlay is projected to reach 21.7 percent of GDP, compared with 20.5 percent of GDP in 2015. Collection remains remarkable, is projected to reach 18.8 percent of GDP, compared with 18.5 percent of GDP in 2015 (Figure 26). The overall fiscal deficit (including grant) is therefore expected to widen to 1.2 percent of GDP in 2016.

²⁰ 2015 Annual Report, Banking Supervision, the National Bank of Cambodia. See http://www.nbc.org.kh/download_files/supervision/sup_an_rep_eng/AnnualReport-2015_ENG.pdf

²¹ Annual report, General Directorate of Banking Supervision, National Bank of Cambodia (2015).

In 2015, despite the rising wage bill, the overall fiscal balance (including grants) narrowed to 0.1 percent of GDP due to a positive revenue performance and slower disbursements.

Figure 26. Despite rising public sector wage, fiscal consolidation continues supported by good collection, percent of GDP



Source: The Cambodian authorities and Bank staff estimates and projections

a) Revenue composition

The strong revenue performance has continued. Domestic revenue is growing at about 15 percent year-on-year with good collection registered across the main revenue sources (Figure 27).²² Domestic revenue is expected to reach about 18.8 percent of GDP in 2016.

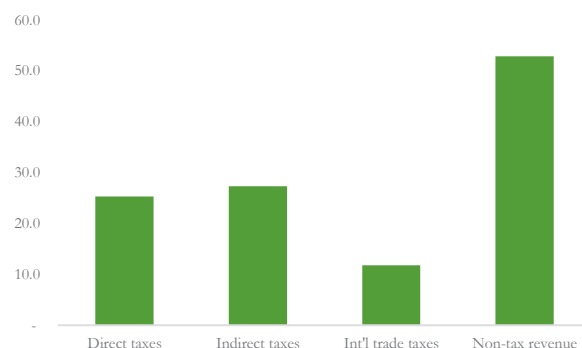
In 2015, revenue collection was impressive and higher than an earlier estimate, reaching 18.5 percent of GDP. Gains have been registered, particularly, in excise, VAT on imports, profits taxes, trade taxes and non-tax revenue (Figure 28).

This positive performance has been underpinned by improved implementation of import tariffs, anti-smuggling efforts, arrears collection and enhancements in tax compliance with a focus on tax audits and taxpayer services, among others. In addition, continued expansion of taxable sectors such as the construction and services sectors with their rising contribution to economic growth, has also helped.

²² For more detailed latest fiscal performance, see http://www.mef.gov.kh/documents/shares/publication/tofe/gfs_and_tofe_201606_kh.pdf

The overall structure of domestic revenue has progressively shifted, with a rise in direct taxes,

Figure 27: Revenue performance continued be strong during the first six months of 2016, year-on-year percent change

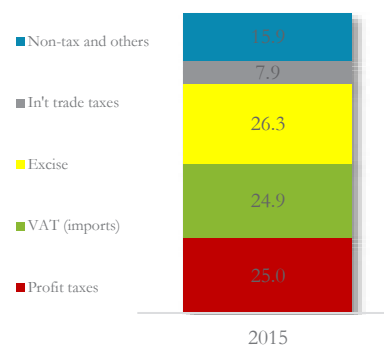


Source: The Cambodian authorities

reaching 3.3 percent of GDP in 2015, compared with 2.9 percent in 2014. Trade-related collection gradually declined, as required under the ASEAN Free Trade Area (AFTA), to 2.8 percent of GDP from 2.9 percent in the same period.

b) Expenditure composition

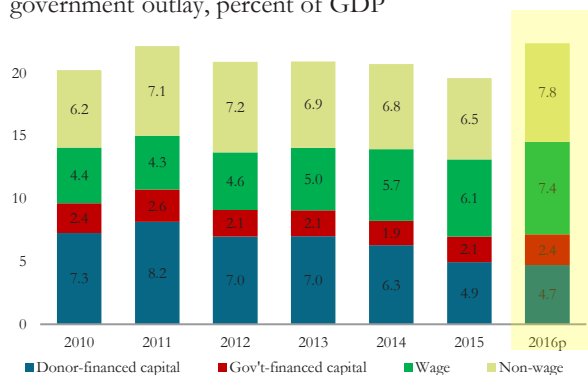
Figure 28: Excise, VAT on imports, and profits tax components contributed a quarter of the total revenue increase in 2015, contribution to revenue growth, percent



Source: The Cambodian authorities

Public outlay continues to be characterized by rising wage bill and declining public investment (caused largely by the gradual reduction in externally financed component) **while the non-wage component receives an initial boost this year** (Figure 29).

Figure 29: The rising wage bill was offset by declining non-wage and externally-financed capital investment, containing overall spending, government outlay, percent of GDP



Source: The Cambodian authorities and Bank staff projections

While improving, the disbursement rate remains low during first half of 2016. Public expenditures grew at about 17.6 percent year-on-year in the first half of 2016 but reached only about 34 percent of the total budgeted expenditures mainly due to slow non-wage and capital budget disbursements.

To meet annual budgeted expenditures, the in-year budget is more often than not allowed to be disbursed in the following year. Slow disbursements were also experienced in 2015 due to initial issues facing the implementation of full program budgeting. The wage bill continued to rise as it is budgeted to reach 7.2 percent of GDP in 2016, compared with 6.5 percent of GDP disbursed in 2015. This is in order to meet the minimum basic monthly salary target of CR 1.0 million (equivalent to about US\$250) by 2018.

Sustaining public investment, which has been shrinking as a percentage of GDP, will be crucial. As Cambodia has now reached lower middle-income status, development partner-financed capital budget is steadily declining, shrinking to 4.9 percent of GDP in 2015 from 6.3 percent of GDP in 2014. This is likely to pose a challenge in the future unless domestically financed public investment (as well as spending efficiency) is boosted to compensate for the decline. Public

investment is needed to improve physical infrastructure supporting transport, logistics, education and health services, which will in turn help enhance the country's competitiveness and achieve more balanced economic development.

c) Fiscal balance

The overall fiscal deficit (including grants) is projected to remain largely subdued, at 1.2 percent of GDP in 2016. Excluding grants, the fiscal deficit is projected to reach 2.8 percent of GDP against the budgeted deficit of 4.8 percent of GDP. This is slightly higher than the overall fiscal deficit (excluding grants) of 2 percent of GDP achieved in 2015. The deficit continues to be financed by external funds. Fiscal consolidation efforts during the past several years have allowed the authorities to increase government deposits, which rose to 10.0 percent of GDP, or US\$2.0 billion by mid-2016. These deposits can be used as a cushion during times of shocks. Cambodia previously introduced a fiscal stimulus, amounting to about 2 percent of GDP, to mitigate the negative impacts of the 2008-09 global financial crisis. Fiscal policy has been largely the sole policy instrument to maintain macroeconomic stability, as the country's monetary policy is constrained by its high level of dollarization.

The World Bank/IMF debt sustainability analysis (DSA) conducted in 2016 indicates that Cambodia's debt distress rating remains low, with all debt burden indicators projected to remain below their respective thresholds. The results also indicate that debt sustainability continues to be vulnerable to shocks to economic growth, exports and the fiscal position, calling for continued structural reforms to bolster the economy's resilience against external shocks and to mobilize domestic revenues. At the end of 2015, the estimated stock of Cambodia's external public debt, including arrears, stood at around US\$5.7 billion, or 31.6 percent of GDP. Note that Cambodia's debt distress rating has been consistently low since 2011, mainly underpinned by the overriding principle of only borrowing only on concessional terms.²³

²³ The concessional terms borrowed are those with a grant element of 35 percent or above.

Outlook and risks

The outlook remains favorable. Growth is projected to be sustained at 6.9 percent in both 2017 and 2018, boosted in part by an increase in government spending during the commune elections in 2017 and the general elections in 2018. In the medium-term, growth will likely continue

Table 5: Selected economic indicators, projections 2016 – 2018

	2015	2016p	2017f	2018f
Real GDP growth, at constant market prices	7.0	7.0	6.9	6.9
Real GDP growth, at constant factor prices	6.4	6.4	6.4	6.4
Agriculture	0.0	0.1	0.1	0.1
Industry	3.6	3.7	3.0	2.6
Services	2.8	2.7	3.4	3.6
Inflation (Consumer Price Index)	1.3	3.2	3.4	3.5
Current Account Balance, excl. official transfers (% of GDP)	-10.6	-10.2	-10.1	-10.1
Exports, goods and services (y/y % change)	7.3	9.0	9.2	8.6
Imports, goods and services (y/y % change)	8.2	9.0	9.4	8.5
Foreign Direct Investment, US\$ millions	1,654.4	1,700.8	1,799.1	1,697.1
Fiscal Balance, incl. grants (% of GDP)	-0.1	-1.2	-3.4	-3.4

Source: The Cambodian authorities and World Bank staff projections.

p = projection, f=forecast

to be driven by garment exports, tourism and services, strategically underpinned by regional integration (Table 5). The agriculture sector is expected to improve marginally due to better weather conditions this year and likely to expand gradually in the near term, thanks to concerted efforts by all stakeholders, in particular the public sector. The current account deficit is expected to improve broadly with continued strong exports and depressed oil prices in the short-term and slower imports growth due to gradual adjustments in the construction sector (and the completion of large power generation projects), as well as continued progress on import substitution in the

medium-term. Export resilience, however, will increasingly depend on Cambodia's ability to remain competitive in the mid-term, given rising wages, as well as on firms being able to add value and introduce product diversification.

A gradual expansionary fiscal policy started this year and is expected to continue in the short- to medium term. A rising wage bill, election-related spending and the needs to boost public investment are likely to keep expenditure on the rise. However, unless there is a review of the tax and investment incentive system in the short-term, year-to-year gains in revenue are expected to decelerate gradually over the medium term in the absence of any tax policy changes.

Risks to this outlook include potential uncertainty related to the commune and general elections in 2017 and 2018, respectively, a sharp decline in the construction and real estate sector, fallout from a rise in US interest rates, regional tensions and slower global growth.

Key messages and policy options

Economic diversification is important through reforms to improve competitiveness. The economy remains largely dependent on narrowly based exports with garment (and footwear) exports accounting for about 80 percent of total merchandise exports. Enhancing competitiveness is therefore key to ensuring Cambodia's future economic success. As discussed in the selected issue on the Garment Sector in Perspective, the garment industry is exposed to increasing competition from Vietnam which has also developed upstream in the sector together with emerging competition from Myanmar which is opening up to foreign investment. Due largely to rising wages and US dollar appreciation, the garment industry is under pressures to cut costs and gradually add value to its products by incorporating printing, embroidery and washing and vertically integrating to the extent possible. It will be crucial to reduce energy costs to allow for manufacturing product diversification which tends to be energy intensive and to address

skills gaps (as well as to achieve skills upgrade). Close collaboration between the public and the private sector will also be necessary to improve Cambodia's connectivity to neighboring countries through better logistics, competitive transportation costs and facilitated trade, while further improving physical infrastructure, given that Cambodia hopes to progressively position itself as a regional logistics hub in view of its strategic location and proximity within ASEAN. In addition, given potentially substantive negative impacts of the EU-Vietnam Free Trade Agreement (EVFTA) and the Trans-Pacific Partnership (TPP) on Cambodia's garment exports, it will be important to devise a concrete plan to improve competitiveness and diversifying export sectors. Structural reforms to make Cambodia's tradeable sector more competitive is core to improving competitiveness of the economy.

Promoting local participation in the garment industry will be important including encouraging more supporting industries to the garment sector from locally-owned small and medium-sized enterprises. Given the “footloose” characteristics of its garment industry together with the existing ownership structure whereby there are only a handful of domestic investors, garment factories can be relocated relatively quickly from Cambodia to more attractive countries, if they face a squeeze in profit margins due to rising input costs, higher taxes, less favorable preferential trade treatment, or an economic slowdown in key export markets. Promoting joint ventures and partnerships between domestic and foreign investors may also be a way forward.

Managing risks arising from the construction boom will be important for maintaining economic resilience. While continued strong activity in the construction activity supports growth, risks associated with the construction boom are rising. Although the boom is not entirely financed by domestic credit, a sharp decline in the construction sector could cause major economic disruptions, negatively affecting growth and employment. Exposure of households to the

existing real estate boom is likely to be substantial. Therefore, risks arising from the construction boom need to be promptly addressed and their negative impacts timely mitigated. Closely monitoring the construction sector in order to maintain macroeconomic stability is crucial. International experience shows policy options to contain a boom (before it reaches dangerous proportions) include monetary and fiscal tightening and macro-prudential measures. Positive initial steps have been made to monitor and regulate housing development activity by the regulators with the introduction of a regulation called Prakas on Housing Development Management in August 2016. How successful the implementation of the regulation will be remains to be seen.

Developing tourism further as growth engine. Given untapped potentials as Cambodia is endowed with countless historical, cultural and natural destinations, the tourism sector can be revitalized so that it once again becomes a strong engine of growth. While positive initial steps have been made by establishing more connecting flights from Japan and other countries (and regions), introducing the “China Ready” initiative aimed at attracting 2 million Chinese visitors by 2020 and adopting “Two Kingdoms, One Destination”, a joint tourism initiative with Thailand with single visas, diversification of tourist attraction sites beyond the Angkor Wat complex appears necessary and can be supported by public-private sector collaboration.

Closing the human opportunities gap. Despite the reduction in extreme poverty, the share of non-poor but economically insecure households has been growing, with very limited mobility towards economic security since 2009. This is in part because of limited human capital or other assets such as land. The challenge for Cambodia, is to close gaps in human development and build the foundations for a middle-class society, while also investing in programs to promote the resilience of households and help minimize their vulnerability.

Selected Issue – Cambodia’s Garment Sector in Perspective

I. An overview of the garment sector

Cambodia started exporting garments in the mid-1990s and has withstood the increased competition in world markets following the removal of quota, Multi-Fiber Agreement (MFA) quantitative restrictions in 2005. Underpinned by low wage, abundant labor and a liberal trade and investment regime, the labor intensive industry has thrived in Cambodia and become a major source of foreign exchange. Investors have brought in technology and supervisory personnel from abroad, which has helped overcome Cambodia’s disadvantages in infrastructure and human capital. Given its nascent manufacturing sector, Cambodia’s domestic supply chain and supporting industries for the garment sector are either insufficient or completely missing. The industry therefore uses raw materials, fabric and other inputs imported mainly from China. Frequent dialog and consultation under public-private sector forums have also helped to foster the sector. The garment industry has therefore enjoyed strong production and employment growth, with an annual production level of close to 200 million dozens produced by over 600 garment factors that employ more than half a million workers.

Garment products are almost entirely exported, mainly to the European Union (EU) and the United States (US). While export destination diversification has partly been achieved, the sector remains heavily reliant on two main export markets, namely the EU and US markets, which together account for 73 percent of total garment exports. The garment sector has now become the most dynamic driver of economic growth for Cambodia. Last year, the garment (and footwear) sector accounted for one-third of total real growth. Evidence also shows that garment production has moved up the value chain, while Cambodia’s market share is also growing. The garment industry has therefore contributed significantly to economic growth, employment and poverty reduction in Cambodia.

However, the sector is facing rising competition from regional low-wage countries, while Cambodia’s minimum wage is rising. Myanmar is one of several emerging low-wage and abundant-labor countries. Myanmar’s minimum wage, which is about two-thirds that of Cambodia, is currently boosting its fast-growing garment industry.²⁴ Meanwhile, anticipation of free trade access by Vietnam under the EU-Vietnam Free Trade Agreement (EVFTA) and the Trans-Pacific Partnership (TPP) is fueling the appetite for investing there, although in some cases, its tariff dismantling periods such as those on textiles and apparel stretch from three to five years.²⁵ Cambodia is currently enjoying “Everything But Arms” or “EBA” preferential treatment under the EU’s Generalized Scheme of Preferences (GSP). When textile and apparel tariff elimination under the EVFTA takes effect, Vietnam will compete with Cambodia for free access to the EU market on an equal footing.²⁶

²⁴ Myanmar’s minimum wage is 3,600 kyat for 8-hour work or about US\$89.4 a month since 2015. See http://www.nwpc.dole.gov.ph/pages/statistics/stat_comparative.html

²⁵ Trans-Pacific Partnership aim at eliminating **more than 18,000 taxes and** other trade barriers among 12 countries: Australia, Canada, Japan, Malaysia, Mexico, Peru, the United States, Vietnam, Chile, Brunei, Singapore and New Zealand. The TPP Parties agree to **eliminate tariffs on textiles and apparel and most tariffs will be eliminated immediately**, although tariffs on some sensitive products will be eliminated over longer timeframes as agreed by the TPP Parties. However, there are specific rules of origin that require use of yarns and fabrics from the TPP region and a textile-specific special safeguard to respond to serious damage or the threat of serious damage to domestic industry in the event of a sudden surge in imports. See <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2015/october/summary-trans-pacific-partnership>. For EU-Vietnam Free Trade Agreement. EU duties on textile apparel have dismantling periods stretching from five to seven years for the more sensitive items and three years and entry into force for less sensitive goods. Footwear also receives the longest EU staging of seven years for sensitive EU items and three years or entry into force on items which are less sensitive. The EU offered mostly duty-free tariff rate quotas for Vietnamese rice exports. See http://trade.ec.europa.eu/doclib/docs/2016/june/tradoc_154622.pdf.

²⁶ Entry into the EBA is automatic and, unlike other GSP arrangements, the EBA has no time-limit. See http://trade.ec.europa.eu/doclib/docs/2013/april/tradoc_150983.pdf

II. Recent developments

1. Garment and textile industry investment and employments

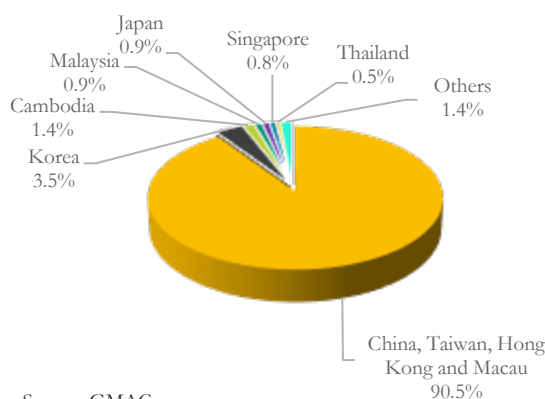
a. Investment in the garment sector.

Table S1: Garment and footwear FDI position (stock)

Year	Stock (US\$ million)	Change (US\$ million)	% of total
2010	1,548		17.5
2011	1,961	413	17.7
2012	2,659	698	19.0
2013	3,273	614	19.6
2014	3,950	677	20.5

Source: 2014 FDI survey, National Bank of Cambodia

Figure S1: Ownership of the garment factories, in percent of total



Source: GMAC

The garment industry has expanded rapidly with a substantial proportion of FDI inflows directed into the sector. Total investment into the sector reached US\$3.9 billion (Table S1) at end-2014 (latest available data). Unlike Bangladesh, Cambodia's garment sector is largely invested in by foreign investors, mainly from China (Figure S1). From the total of more than 600 factories, under 7 percent are owned by a majority of Cambodian share-holders and only 5 percent of those are 100 percent Cambodian owned.²⁷ While Chinese FDI in the garment sector appears large, at US\$ 3.6 billion as of 2014, it represents less than 0.8 percent of total Chinese outward FDI for the sector.²⁸ FDI in the garment (and footwear) sector is still rising. A recent survey of FDI (2014) by the central bank also found that China's relocation of some of its garment factories in Cambodia is the main reason for the increase in net new factories. Given the "footloose" characteristics of its garment industry together with their existing ownership structure, garment factories can be relocated relatively quickly from Cambodia to more attractive countries, if the sector faces a squeeze in profit margins due to rising input costs, higher taxes, less favorable preferential trade treatment or an economic slowdown of key export markets.²⁹

b. Employment – jobs created by the sector are important to the economy.

The sector created an annual average of 40,000 new jobs or a quarter of total annual job creation in the period 2010-15, while the number of garment factories increased by an average of 60 factories per year in the same period. In 2015, total employments reached 522,000 jobs, while the total number of factories was 626 (Table S2).³⁰ In 2016, employments created by the garment industry has increased further, driven largely by the growing number of subcontractors, although it remains to be established whether the number of garment factories increased during the first half of 2016.³¹ The garment sector also contributed indirectly to employment generation in retail, trade and transportation.

²⁷ Presentation by Garment Manufacturers' Association in Cambodia (GMAC) in April 2016.

²⁸ Chinese FDI stocks in garment (and footwear) by end-2014 is estimated at 3.58 billion (3.95 x 90.5%) (Table 1B) or approximately 0.83 percent (3.58/430) of total Chinese outward FDI with total Chinese outward FDI of US\$ 430 billion during 2000-11. See the Transformation of the Clothing Industry in China, ERIA discussion paper series (2015). Therefore, including additional Chinese outward FDI during 2012-2014, the share should be even smaller.

²⁹ Based on a March 2016 Synthesis Report, presented by Garment Manufacturers' Association in Cambodia (GMAC) in April 2016.

³⁰ According to the Ministry of Commerce. However, different data sources provide different numbers of garment workers and factories, for instance, the Ministry of Industry and Handicraft report showed there were 780 factories which employed 747,229 workers in 2015.

³¹ GMAC said more garment factory closures than opening during the first half of 2016. However, the Ministry of Industry and Handicraft reported in May 2016 that total garment factories is 803 employing 764,818 workers or 17,588 increase during the past 5 months of 2016. Some inconsistencies between employments and garment factory numbers reported by the Ministry of Commerce and those by the Ministry of Industry.

Table S2: Employments and garment factories

	1995	2000	2005	2010	2011	2012	2013	2014	2015
Employment ('000)	18	161	284	319	327	360	418	475	522
Garment factories	20	190	247	262	300	400	469	558	626

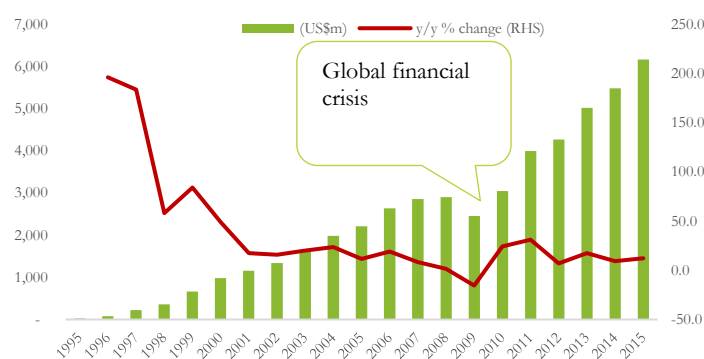
Source: The Cambodian authorities

2. Garment exports, products and world market share

a. Garment exports

Garment production goes mainly towards exports. Garment exports are Cambodia's largest earner of foreign currency, generating US\$ 6.2 billion (Figure S2) or 72 percent of total merchandise exports in 2015. Garment exports continue to grow rapidly, except in 2009 when the global financial crisis hit Cambodia. Garment exports have been expanding at an average year-on-year growth rate of 11 percent in value terms during the

Figure S2: Solid garment export performance (except during global financial crisis) continues, US\$ million



Source: Ministry of Commerce

period 2010-15. Supported by export market expansion to the EU under “EBA” preferential trade treatment, the return of a relatively stable labor market and the gradual shift towards higher value-added products³² appear to have helped the sector expand, overcoming challenges on the domestic front despite the appreciation of the US dollar. The volume of garment exports continues to drive export growth, while the contribution from rising price has recently started to pick up (Table S3). Rising volume has continued to drive garment exports growth over the past four years, while the contribution from rising prices also drove export growth in 2015, accounting for 28 percent of the

increase in total garment exports in that year. During the first half of 2016, while garment exports continue to expand in value and volume terms, the contribution from rising garment product prices disappeared.

Table S3: Volume increases contributed 100 percent of the total increase in export in the first half of 2016.

Increase due to:	2012 (%)		2013 (%)		2014 (%)		2015 (%)		H1 2016 (%)	
Volume	418.0	149.4	573.5	76.2	561.8	121.3	487.2	71.9	299.0	100.0
Price	-138.2	-49.4	178.8	23.8	-98.8	-21.3	190.7	28.1	-0.1	0.0
Total	279.9	100.0	752.3	100.0	463.0	100.0	677.9	100.0	298.9	100.0

Source: The Cambodian authorities

Garment exports to the EU—the largest export market—absorbed 42 percent (or US\$1.9 billion) of total garment exports and continue to drive Cambodia's overall garment exports growth. However, garment exports to the US, accounting for 31 percent (US\$2.6 billion) of total garment exports, have already peaked.

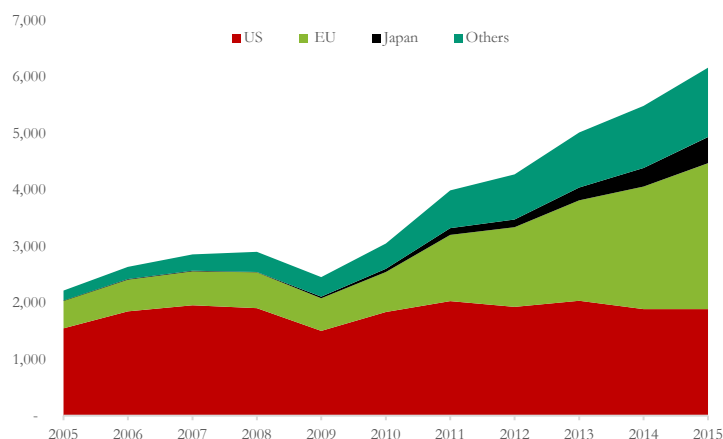
³² While the garment sector seems to be shifting towards higher value-added products in 2015, it is necessary to examine detailed exported products and prices to confirm this.

Recently, strong garment exports growth (Figure S3) has been underpinned by the gradual recovery in major high-income countries, in particular in the Euro area and the US. Garment exports performance is expected to remain strong in 2016, given continuing high growth of imports of fabric, the main input for garment production.

b. Garment products

Unlike Vietnam, the garment industry in Cambodia was not built on earlier import-substituting industrialization in textiles, but was developed almost entirely by an influx of foreign firms.³³ The

Figure S3: Among the largest garment exports markets, EU market is growing (contributing 60% of total increase in 2015) **while US market stagnated, US million**



Source: The Cambodian authorities

lack of the upstream and downstream segments of the apparel chain continues to constrain the industry into focusing on the cut-make-trim (CMT) stage of production with virtually all inputs imported, most commonly from China. So, while Cambodia nonetheless operates within global value chains, it mainly assemble imported materials and parts into finished products for exports. The CMT stage of production is found to be financially and technologically undemanding and generally less profitable than other stages.³⁴ In addition, garment products that Cambodia exports to the EU and the US are similar. Eight of top ten major exported products under Harmonized System (HS) codes are the same.

• EU imports

Table S4: Main garment products exported to the EU market and their shares, percent

HS Code	Top 10 garment products	2010	2011	2012	2013	2014	2015
6110	Jerseys, pullovers, cardigans, etc. knitted or crocheted	41.4	38.4	28.3	25.7	23.8	22.0
6104	Women's suits, dresses, skirts etc. & short, knit/crocheted	10.6	12.6	12.0	12.7	14.1	15.0
6109	T-shirts, singlets and other vests, knitted or crocheted	11.0	12.0	13.2	11.8	13.1	12.0
6204	Women's suits, jackets, dresses skirts etc. & shorts	0.8	1.4	1.6	10.5	9.8	11.7
6203	Men's suits, jackets, trousers etc. & shorts	3.3	4.5	3.7	10.7	9.7	9.1
6205	Men's shirts	1.4	1.3	1.6	2.7	3.0	2.9
6108	Women's slips, panties, pyjamas, bathrobes etc., knitted/crocheted	1.0	1.0	1.6	2.2	2.7	2.9
6102	Women's overcoat, cape, etc., knitted/crocheted, o/t of hd 61.04	2.8	4.6	6.0	3.5	3.8	2.8
6112	Track suits, ski suits and swimwear, knitted or crocheted	2.6	4.2	8.5	2.3	2.6	2.7
6103	Men's suits, jackets, trousers etc. & shorts, knitted/crocheted	2.9	2.8	2.4	1.8	2.1	2.4
Total share (%)		77.8	82.8	78.9	83.9	84.7	83.5

Source: UN COMTRADE

³³ Challenges to the Cambodian Garment Industry in the Global Garment Value Chain (2009), Ritsumeikan Center for Asia Pacific Studies (RCAPS), Ritsumeikan Asia Pacific University.

³⁴ From downturn to recovery: Cambodia's garment sector in transition, ILO, 2011

The top ten products accounting for about 84 percent of Cambodia's total exports to the EU market are: jerseys, pullovers, cardigans, women's suits, dresses, skirts, shorts, T-shirts, women's slips, panties, pyjamas, bathrobes, over-coats, capes, track suits and others (Table S4).

• US imports

The top ten products accounting for about 80 percent of Cambodia's total exports to the US market include: jerseys, pullovers, cardigans, women's suits, dresses, skirts, shorts, T-shirts, women's slips, panties, pyjamas, bathrobes, over-coats, capes track suits and others (Table S5). Only two products that are among the US market's top ten, namely babies' garments (HS code 6111) and men's underpants, pyjamas, bathrobes etc. (HS code 6107) are not in the EU market's top ten. Another two products that are in the EU market's top ten, namely men's shirts (HS code 6205) and women's overcoats, capes etc. (HS code 6102) are not among the US market's top ten.

Table S5: Main garment products exported to the US market their shares, percent

HS Code	Top 10 garment products	2010	2011	2012	2013	2014	2015
6110	Jerseys, pullovers, cardigans, etc. knitted or crocheted	20.3	21.7	20.8	20.8	19.5	18.5
6104	Women's suits, dresses, skirts etc. & short, knitted/crocheted	11.0	11.0	12.0	12.7	13.4	13.4
6111	Babies' garments, knitted or crocheted	3.4	4.1	4.7	6.6	8.2	8.8
6204	Women's suits, jackets, dresses skirts etc. & shorts	13.9	12.6	11.0	8.8	8.0	8.7
6108	Women's slips, panties, pyjamas, bathrobes etc. knitted/crocheted	7.0	7.5	7.2	8.0	8.6	8.7
6203	Men's suits, jackets, trousers etc. & shorts	9.5	9.3	9.5	9.7	7.8	6.7
6109	T-shirts, singlets and other vests, knitted or crocheted	5.4	4.8	5.4	5.0	4.7	5.1
6107	Men's underpants, pyjamas, bathrobes etc., knitted/crocheted	4.0	2.8	2.9	3.3	3.8	4.1
6103	Men's suits, jackets, trousers etc. & shorts, knitted/crocheted	2.5	2.1	2.1	2.5	3.0	3.7
6112	Track suits, ski suits and swimwear, knitted or crocheted	2.0	1.9	2.5	2.5	2.8	2.8
Total share (%)		79.0	77.9	78.0	79.9	79.9	80.4

Source: UN COMTRADE

As reflected in the Tables S4 and S5 above, over the past five years the evolution of the top ten products appears to point to a rising share of more sophisticated and higher value added products. Specifically, for both EU and US markets, there has been an expansion in women's garments (HS 6104) including women's undergarments (HS 6108) versus less sophisticated articles (HS 6110) serving both men and women. For the EU market, women's articles favoring knitted or crocheted apparel under HS 61 (consistently identified in Box 1 on Exports of Textile and Apparel Articles – *Cambodia is a strong competitor for Vietnam in the EU market*) are expanding faster than men's articles, while for the US market, babies' garments are rapidly emerging.

Retail brands sourcing from Cambodia include H&M, Nike, Levi, Old Navy, Adidas, Calvin Klein, Gap, Puma, Clarks, Marks and Spencer, Tesco, Inditex, N Brown Group, Tchibo, Next, New Look, C&A, Walmart and more.³⁵

³⁵ Cambodia Factsheet, Gillian Kane, Facts on Cambodia's Garment Industry

3. Wages, output and gender

a. Wages

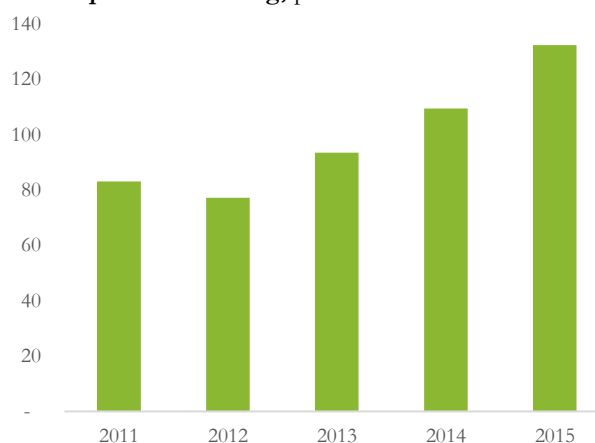
The minimum wage in the garment sector has increased rapidly over the past four years, averaging 23.1 percent during 2012-14 as it rose to US\$140 a month in 2016 from US\$61.0 a month in 2012 (Table S6). The widespread labor unrest that occurred in late 2013 and early 2014 appears to have pressured the minimum wage increases in 2014 and 2015. As a share of per capita GDP, the minimum wage in the garment sector is rising, reaching 133 percent in 2015 (Figure S4). Minimum wages of Vietnam and Bangladesh are also rising but at a slower pace than in Cambodia (Table S7). Minimum wages as a share of per capita GDP in Vietnam and Bangladesh are 78 percent and 67 percent, respectively. The garment sector accounts for the majority of paid employment in Cambodia and is the largest formal sector in the economy.

Table S6: The minimum wage in the garment sector rose in 2013-15

Year	Minimum wage (US\$/month)	Change (y/y, %)
2008	56	0.0
2009	56	0.0
2010	61	8.9
2011	61	0.0
2012	61	0.0
2013	80	31.1
2014	100	25.0
2015	128	28.0
2016	140	9.4

Source: Ministry of Labor and Vocational Training

Figure S4: Cambodia's minimum wage as a share of GDP capita is also rising, percent



Source: WDI and the Cambodian authorities

It is estimated that the total wages paid to garment workers in the entire country are worth about US\$1.2 billion a year. The employment and remittances to their home areas of such a large pool of poorly educated and mostly rural women turned garment workers has had a significant impact in terms of reducing poverty.

Table S7: Evolution of minimum wages in Vietnam and Bangladesh

US\$/month	2010	2011	2012	2013	2014	2015	2016
Vietnam ¹	54-72	56-80	65-95	80-112	90-128	96-138	107-156
Bangladesh ²	25	39	39	68	68	68	68

Source: ILO, American Chamber of Commerce Vietnam and others.

1/ All private sector. Vietnam's minimum wages are classified by four different regions: region 1 is the highest, covering urban areas such as Hanoi and Ho Chi Minh City; region 2 consists of suburban areas; region 3 includes provincial areas; and finally region 4 is for the remaining areas (largely rural areas), the lowest. The numbers above represent the lowest (region 4) and the highest (region 1) of the four regions.

2/ Garment sector. In many cases, salary increases effective in October, November or December

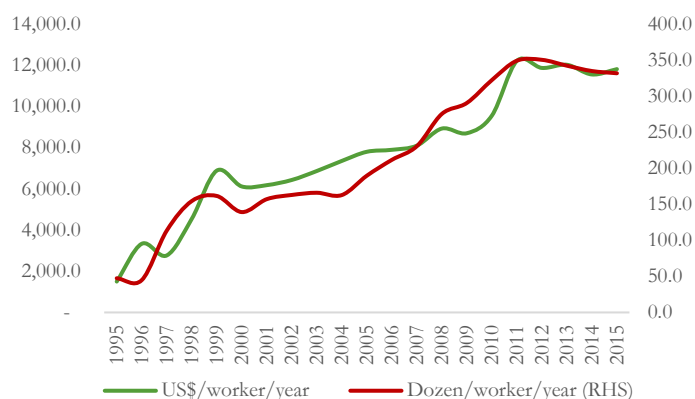
b. Annual garment export output per worker

It is important to monitor productivity in the garment industry. However, productivity is difficult to measure as disaggregate production and employment data are not available.³⁶ Using aggregate export volume (and

³⁶ Incoming Systematic Country Diagnostics Study will try to compute.

value) as a proxy, productivity can be roughly measured using the total garment products in volume (and in value) terms and the total number of garment workers that produce them. Both volume and value of garment exports per worker trended downwards in the period 2013-15. This may have been partly due to the negative impacts of poor industrial relations with widespread labor unrest occurring in 2013 and 2014, resulting in significant disruption to garment production as well as the reduction in overtime, reported by Garment Manufacturers Association in Cambodia (GMAC).³⁷

Figure S5: Garment export volume (and value) per worker has been stagnated since 2011



Source: World Bank staff estimates

c. Gender

Thanks to the garment industry, Cambodia has been able to incorporate women into the productive and formal economy. The industry is the main formal sector employer bringing hundreds of thousands of informal workers, mostly women with limited education working largely in the agriculture sector to participate in formal manufacturing jobs. Women belonging to relatively large families from rural areas migrating to work as garment workers mainly for economic reasons comprise about 90 percent of all total garment workers. Wages provide them with the opportunity not only to increase their incomes and achieve economic independence but also to support

their families back in their home villages and to send their siblings to school. The role of women garment workers therefore should not be underestimated. For most women, working in the garment industry is perhaps their first experience of formal employment.³⁸ Understanding working conditions including paid annual, sick and maternity leave entitlements provided by the Labor Law will be important in promoting good industrial relations.³⁹

Living costs in the main cities where garment factories are located appear to be high. While wages are rising, most garment workers still cannot afford to have children living with them due to the high cost of accommodation and childcare expenses. Children are often forced to live with their grandparents back in their home villages. Garment workers with children typically spend about 50 percent more than single workers do on their children's living and educational expenses.⁴⁰

Established in 2002, the National Social Security Fund supports garment workers and its members.⁴¹ Currently, two main schemes--occupational risk insurance and medical insurance--are operational, with over one million participating members, of whom just under one million are members employed in the garment and garment-related industries. For the occupational risk insurance scheme, employers are required to contribute 0.8 percent of a worker's average monthly wage, while the medical

³⁷ For more detail, see <http://www.gmac-cambodia.org/default-31-12-14.php>

³⁸ Women and gender issues in trade unions in Cambodian garment industry (2011), ILO

³⁹ Full time employees get 1.5 days of annual leave a month. This equals 18 days per year. The labor law does not require paid sick leave, however, following the policy of the Ministry in charge of Labor, employers should consider providing paid sick leave as follows: (i) 100 percent of wages during the first month of sick leave; (ii) 60 percent of wages during the second and third months; and (iii) unpaid leave from the fourth until the sixth month. Employers must give employees who give birth 90 days (3 months) of maternity leave. Employers must pay employees who have at least one year of seniority half their wages and benefits during maternity leave of 90 days. See <http://betterwork.org/cambodia/wp-content/uploads/2013/05/Cambodian-Labour-Law-Guide-English-2013.pdf>

⁴⁰ Based on interviews with garment workers and unions.

⁴¹ NSSF is run by a governing body chaired by a representative from Ministry of Labor and Vocational Training participated by representatives from the Council of Ministers, Ministry of Economy and Finance, Ministry of Health and workers themselves. See <http://www.nssf.gov.kh> for more details

insurance scheme receives equal contributions of 1.3 percent of a worker's average monthly wage from both the worker and the employer.

III. Contribution to economic growth

Sustained robust economic growth averaging 7.6 percent per year during the past two decades would not have been possible without the substantial contribution by the garment sector, one of the main engines of growth. Specifically, the garment (and footwear) sector contributed an average of 2 percentage points to annual real growth rate in the period 1995-2015 (Figure 7). The sector accounts for about 12 percent of the country's gross domestic product (GDP) and generates US\$6.2 billion in export value (76 percent of total exports in 2015), representing the largest share of Cambodia's foreign currency earnings. To find out the size of the contribution from the garment sector (as well as the industry sector) to output and employment growth, decomposition is carried out below.

1. Decomposing output growth and employment⁴²

Using the Cambodia-Socio Economic Survey, the national accounts and garment and footwear employment data, decomposition of value added growth and employment by sector is conducted during the period 1995-2015. This is then further divided into three sub-periods, namely 1995-2000, 2000-09 and 2009-15 to look more closely at the evolution of structural changes in each sub-period. As the existing classification in the national accounts does not allow for disaggregation of the garment and footwear sector, the two segments are analyzed as one.⁴³

a. Entire study period covering 1995-2015

The garment (and footwear) sector contributed substantially to real growth, accounting for about 30 percent of real growth during the past 20-year period. It contributed a 2.2 percentage points of the 7.7 percent real growth (Figure S6), while the entire industry sector's contribution was 2.8 percentage points.⁴⁴

In terms of employment growth, the garment (and footwear) sector's contribution was modest, accounting for 0.7 of a percentage point (Figure S7). This represents one quarter of total employment growth during this period which is relatively high at 2.7 percent, while the entire industry sector contributed as much as 1.9 percentage points.

b. Sub-periods

Strong performance in the 1995-2000 sub-period: the contribution made by the garment sector to real growth was the largest among the three sub-periods. This reflected rapid expansion of garment exports, albeit from a very low base, growing at an average rate of 84 percent a year. During this period, the garment sector accounted for 3.1 percentage points of 7.6 percent real growth. This was above the contribution by the entire industry sector which accounted for only 2.9 percentage points. **However, the garment sector's contribution to employment growth during this sub-period remained modest at 0.8 of a percentage**

⁴² For more details see <http://globalpractices.worldbank.org/mfm/Pages/SitePages/Growth%20Analysis%20Tools.aspx>

⁴³ The footwear sector was relatively small, with a total export value of less than US\$ 100 million a year prior to 2010, while total garment sector export value reached as much as US\$ 2.5 billion in 2010. Export value of the footwear sector, however, expanded rapidly, reaching US\$ 660 million in 2015.

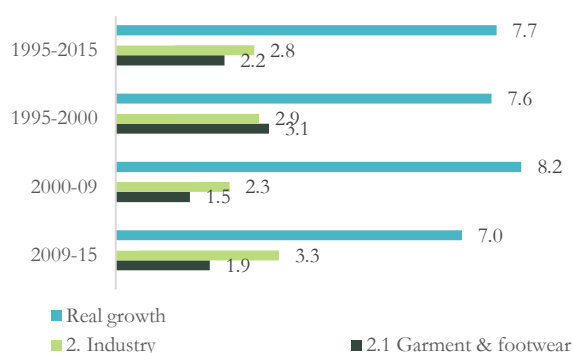
⁴⁴ Slightly different periods: 1996-2013 for Vietnam and 1996-2010 for Lao PDR due to non-availability of data of the two countries in WDI.

point (similar to that of the entire study period) of total employment growth during this sub-period which was the highest at 3.7 percent.

Deceleration in the 2000-09 sub-period: the garment and footwear sector contributed the smallest due largely to decelerating garment export performance in the run up to the 2008-09 global financial crisis, at 1.5 percentage points to real growth, while this sub-period witnessed real growth rising fastest, at 8.2 percent. **The garment sector also contributed the least, at 0.2 of a percentage point of total 2.6 percent employment growth.**

Recovery in the 2009-15 sub-period: the garment and footwear sector contributed handsomely at 1.9 percentage points to real growth of 7.6 percent. The entire industry sector, however, accounted for the largest contribution, at 3.3 percentage points, reflecting new emerging sectors such as the construction and other manufacturing sectors which grew rapidly during this sub-period. **For employment growth, the garment sector accounted for 0.8 of a percentage point of total employment growth during this sub-period which was 2.1 percent.**

Figure S6: Decomposition of real growth in value added, percentage points



Source: World Bank staff estimates

Figure S7: Decomposition of growth in employment, percentage points



Source: World Bank staff estimates

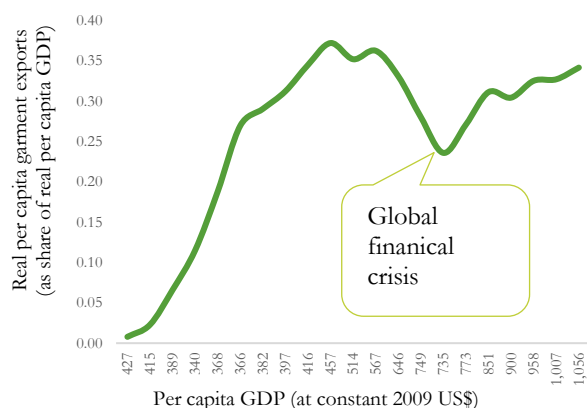
As discussed above, it is clear that while the garment sector contributes significantly to real growth, it only generates modest growth in employment. Moreover, it is important to note that structural transformation of the economy has led to a steady decline in total employment growth which dropped from 3.7 percent during 1995-2000 sub-period to 2.6 percent in 2000-09 sub-period and 2.1 percent in 2009-15 sub-period while Cambodia's working age population (15-64 years) grew at an average rate of 2.6 percent per year during the period 2009-14, rising to 10 million persons in 2014 from 8.8 million persons in 2009.⁴⁵

2. Garment sector evolution - international evidence

There may still be some scope for Cambodia's garment sector to expand further. Cambodia's real GDP per capita (at constant 2009 US dollar) reached only US\$1,055 in 2015 which appears to be below a

⁴⁵ For a more detail discussion, see Employment, Income and Consumption section (page 11) of April 2016 Cambodia Economic Update

Figure S8: Cambodia's per capita income and "per capita garment exports" remain below the "threshold" of between US\$ 1,150 to 2,000



Source: World Bank staff estimates

“threshold” level of per capita GDP after which per capita garment exports begin to decline (Figure S8).⁴⁶ Evidence from garment-exporting countries seems to point to a “threshold” level of between US\$1,150 and US\$2,000 real per capita GDP. For instance, real per capita exports of garments in Thailand grew until the country reached a “threshold” per capita GDP of between about US\$2,000 (in constant 2000 US dollars) and around US\$1,150 in Sri Lanka. Before reaching this threshold, a country’s export basket has been found to show a relatively diversified mix of basic and higher value garments. With its US\$1,055 (2009 US dollars) per capita, Cambodia is approaching the threshold and its garment exports continue to grow, averaging at about 15 percent during the period 2010-15.

Cambodia is experiencing a similar evolution to Thailand, Sri Lanka and the Philippines when their garment exports were diversified before their per capita garment exports began to decline and the subsequent contraction of their garment sectors. Cambodia’s garment sector is experiencing rising wages, the erosion of competitiveness in basic garments and a gradual moving-up the value chain witnessed largely by the recent increase in the average export price of its garments.

3. World market share of Cambodia’s garment exports

Cambodia’s share of the world’s garment export markets has edged up steadily, rising to 2.02 percent in 2015 from 0.9 percent in 2011 (Table S8). Similarly, Cambodia’s shares in the EU and US markets have been rising from 2.16 percent and 0.93 percent in 2011 to 5.07 percent and 2.5 percent in 2015, respectively. As Cambodia’s GDP per capita is still below the threshold, its garment export growth may be sustainable at

Table S8: Cambodia’s shares of the EU, US and world garment exports markets are rising

Cambodia’s share (%) in	2011	2012	2013	2014	2015
the world's garment market	0.90	1.02	1.14	1.14	2.02
the EU garment market	0.95	1.25	1.52	1.81	2.23
the US garment market	0.93	0.82	2.75	2.61	2.50

Source: UN COMTRADE

least in the near term. In the medium- and longer-term, rising competition from regional low wage countries such as Myanmar and Vietnam will prove more difficult for Cambodia to match. With the TPP and the EVFTA, there are significant risks of investment and export diversion away from Cambodia unless key constraints, such as high energy costs, regulatory impediments to

doing business and infrastructure bottlenecks, are successfully addressed.

IV. Opportunities and challenges

1. Opportunities

Cambodia is an attractive investment destination, given its strategic location at the center of ASEAN, creating significant opportunities for integration into regional and global value chains.⁴⁷

⁴⁶ Consolidating and accelerating exports in Bangladesh, Bangladesh Development Series (2012), the World Bank.

⁴⁷ The Investment Climate Assessment 2014 Creating Opportunity for Firms in Cambodia the World Bank

Foreign investors, in particular those that invest in the garment sector in Cambodia, continue to find political stability, a relatively cheap, young and rising labor force, liberal investment and trade policies and preferential access under the EBA GSP to the EU market as favorable conditions attracting their investment.⁴⁸ It is likely that Cambodia will continue to be eligible for EBA preferential access for at least the next 11 years.⁴⁹

An effective minimum wage-setting mechanism has been established. A tripartite Labor Advisory Committee consisting of representatives from the Ministry of Labor and Vocational Training, employer associations and trade unions has so far been successful in handling annual minimum wage negotiations since 2014.⁵⁰ This helps maintain good industrial relations after the widespread labor unrest in 2013 and 2014 disrupted the garment sector and had a negative impact on investors' confidence. All related parties, namely garment workers, unions and factory owners appear to have developed a better understanding of the importance of the garment industry and their mutual interests, as well as the challenges and constraints the industry faces, and as a result, all stakeholders are now working more effectively together to overcome them.

A Cambodian Garment Training Institute has been established.⁵¹ The Institute will help train

Table S9: Electricity tariff in ASEAN Nations (US¢ /kWh) ^{1/}

Country	Commercial	Industrial
Brunei	3.82-15.29	3.82
Cambodia	11.71-15.85	11.71-14.63
Indonesia	5.93-12.19	5.38-10.14
Lao PDR	8.80-10.36	6.23-7.34
Malaysia	9.67-11.10	7.83-10.88
Myanmar	6.17	6.17
Singapore	10.95-18.05	10.95-18.05
Thailand	5.55-5.75	8.67-9.43
Vietnam	4.38-15.49	2.30-8.32

Source: ASEAN Center for Energy (2011)

Poch, K. and S. Tuy (2012), 'Cambodia's Electricity Sector in the Context of Regional Electricity Market Integration' in Wu, Y., X. Shi, and F. Kimura (eds.), *Energy Market Integration in East Asia: Theories, Electricity Sector and Subsidies*, ERIA Research Project Report 2011-17, Jakarta: ERIA, pp.141-172.

Cambodian garment workers in order to bridge the existing human resources gap at middle-management level in the garment industry and to improve its competitiveness.⁵² An insufficiently skilled workforce has resulted in many technical and mid-management positions being filled by foreigners. The Institute, located in the Phnom Penh Special Economic Zone with the most advanced technology being used in the industry, will train Cambodia's unskilled garment workers and other Cambodians to undertake higher level jobs in garment factories. **Long-term training** (12 months, 240 trainees a year) –*technical and supervisory skills training*

designed for those have just finished secondary education and completed university studies. Trainees will become assistants with the aim of filling skilled jobs that are currently predominantly held by non-Cambodian. This targets four qualification areas: (i) garment construction experts (pattern making and adaptation); (ii) garment production engineers (manufacturing processes); (iii) apparel merchandisers (garment designers); and (iv) quality assurance specialists (quality controllers).

⁴⁸ Currently, Bangladesh, Cambodia, Lao PDR and Myanmar are among 49 beneficiary countries. See Everything But Arms (EBA) – Who benefits? http://trade.ec.europa.eu/doclib/docs/2013/april/tradoc_150983.pdf

⁴⁹ Cambodia's eligibility under EBA is expected to continue until it is no longer classified as 'least developed' by the UN. Cambodia is currently classed as "least developed country or LDC" by the United Nations. Graduation thresholds (2015 triennial review): (i) Per capita GNI: \$1,242; (ii) Human Asset Index (HAI): 66 and above; and (iii) Economic Vulnerability Index (EVI): 32 and below. (Cambodia was classified as a lower-middle income economy by the World Bank Group. Cambodia's GNI per capita (Atlas method) for 2015 is estimated at \$1,070 above the threshold for Low Income, which is set at \$1,025 for Bank's 2017 fiscal year.) Eligibility for graduation has to be met at two consecutive triennial reviews (2+3) and graduation takes effect three years (3) after the decision by the General Assembly. When Cambodia is graduated from the LDC, the EU will provide a transition period of three years (3), during which time EBA preferences will continue to apply. See http://trade.ec.europa.eu/doclib/docs/2013/april/tradoc_150983.pdf and http://www.un.org/en/development/desa/policy/cdp/cdp_ldcs_countryfacts.shtml

⁵⁰ In notification 209 issued on 6 August 2013 by the Ministry of Social Affairs, Veterans and Youth Rehabilitation (MoSAVYR), the Royal Government of Cambodia will be arranging a discussion on the increase of the minimum wage for all workers in 2014 through the tripartite mechanism. For more detail, see <http://www.arbitrationcouncil.org/en/post/6/Minimum-wage-determination-in-Cambodia>

⁵¹ CGIT is initiated and managed (under a training project) by the Garment Manufacturers Association in Cambodia (GMAC)

⁵² GMAC 2015 Bulletin. See <http://www.gmac-cambodia.org/bulletin/2015.pdf>

Short-term courses (less than 3 months, 1,600 trainees a year) – *on-the-job technical and supervisory skills training* is evening on-the-job training, open to workers paid for by their companies. Three qualification areas are targeted: (i) on-the-job supervisory skills; (ii) specialized skills in the pattern market, design and merchandizing; and (iii) technical skills: cutters, sewing operators, pressers, electricians and mechanics for the garment industry.

2. Challenges

Table S10: Cambodia's minimum wage and regional comparison

Country	US\$ per month
Cambodia	140.0
Bangladesh	65.8
Myanmar	89.4
Lao PDR	107.5
Vietnam/ ¹	156.0
Mongolia	96.1
Pakistan	103.2
Philippines	203.0
Thailand	251.4
China	201.2

Source: Cambodia's Ministry of Labor, Department of Labor, the Philippines, American Chamber of Commerce Vietnam
^{1/} Region I which has the highest rate.

It appears that the high cost of electricity continue to constrain the development of more sophisticated manufacturing processes, which in turn thwarts diversification. Electricity remains one of the top ten most severe constraints based on the findings of the 2016 World Bank Enterprise Survey.⁵³ A report published in 2012 also found that the electricity tariff is among the highest in the ASEAN (Table S9).⁵⁴ Information from various investors reveals that producing higher value added products, which requires moving away from simple assembling processes to product manufacturing is often energy intensive.⁵⁵ In addition, unofficial fees have been mentioned as being responsible for high transportation costs and underperforming logistics.⁵⁶

Cambodia thus needs to improve its competitiveness by enhancing its connectivity to neighboring countries through better logistics and trade facilitation and by maximizing the policy space surrounding trade and investment to attract and hold these new investors while building clusters around new industries.

Table S11: National holidays in selected regional countries

Country	Number of national holidays (2016)
Cambodia	28
Myanmar	25
Bangladesh	25
Thailand	17
Vietnam	16
Lao PDR	12
China	11

Source: <http://www.officeholidays.com/>

The garment industry is under pressures from rising wages. Cambodia's minimum wage is now comparable to Vietnam's but remains below minimum wages in China, the Philippines and Thailand. The minimum wage in Cambodia is now higher than those in a number of regional countries such as Bangladesh, Myanmar and Lao PDR (Table S10). While it is difficult to accurately compare worker productivity in Cambodia with that of other countries due to the unavailability of data, it seems that the number of working days in Cambodia while similar to Myanmar and Bangladesh, is fewer than those in Vietnam, Lao PDR, Thailand and China (Table S11) due to Cambodia's relatively larger number of public holidays.⁵⁷

⁵³ See <http://www.enterprisesurveys.org/data/exploreeconomies/2016/cambodia>

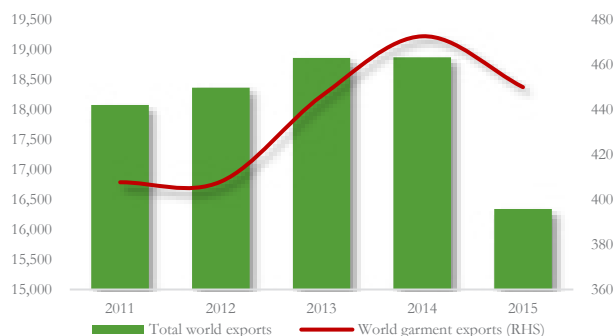
⁵⁴ Poch, K. and S. Tuy (2012), 'Cambodia's Electricity Sector in the Context of Regional Electricity Market Integration' in Wu, Y., X. Shi and F. Kimura (eds.), *Energy Market Integration in East Asia: Theories, Electricity Sector and Subsidies*, ERIA Research Project Report 2011-17, Jakarta: ERIA, pp.141-172. See <http://www.eria.org/Chapter%207-Cambodia's%20Electricity%20Sector%20in%20the%20Context%20of%20Regional%20Electricity%20Market%20Integration.pdf>

⁵⁵ Interviews with investors in Phnom Penh, Manhattan, and Tai Seng Special Economic Zones

⁵⁶ The Investment Climate Assessment 2014 Creating Opportunity for Firms in Cambodia, the World Bank

⁵⁷ Assuming that these countries have 8-hour work day and 6-day work week with similar annual leave allowances

Figure S9: Global trade has been shrinking, along with garment exports, US\$ billion



Source: UN COMTRADE

It is important to note also that global trade has been shrinking since 2014 (Figure S9). While the performance of the garment industry has continued to improve, defying the reduction in global trade in garments, it is not certain how long this will last. Uncertainty surrounding global trade in garments does not bode well for the Cambodian economy which is heavily dependent on garment exports.

a. EU-Vietnam free trade agreement

The EU-Vietnam Free Trade Agreement (EVFTA) will give Vietnam a “level playing field” to compete for the EU market with Cambodia which is currently

enjoying the EU’s EBA preferential treatment with full duty free and quota-free access for all products. Currently, Vietnam mostly faces 12 percent customs tariff for the same garment products that Cambodia largely exports duty free to the EU. Vietnam still maintains a similar market share, compared with Cambodia’s in the EU market (see Box 1). While rules of origin are still required, once it takes effect, theoretically, the EVFTA will immediately eliminate most tariff lines on garment products under Harmonized System (HS) codes 6104 and 6204 (Table S4) (currently classified under Category A of the EU tariff schedule), which account for about one quarter, or US\$700 million of Cambodia’s total exports⁵⁸ to the EU.⁵⁹ Let’s assume that Vietnam’s duty free access to the EU market upon ratifying the EVFTA could result in a drop of 12 percent of Cambodia’s EU market share or US\$ 350 million (or about half of the export value of the impacted products) of Cambodia’s exports to the EU market.⁶⁰ In this case, real growth could potentially decline by up to 1.5 percentage points.⁶¹

However, potential negative impacts on Cambodia’s garment exports may not fully materialize soon after the EVFTA becomes effective. This may be due to a number of factors which include the time lags in garment supply response by Vietnam while Cambodia already operates within global value chains. Another factor is the rules of origin which are often difficult to qualify (note that Cambodia’s garment exports to the EU have expanded substantially only after 2011 when the EU relaxed EBA’s rules of origin requirements).⁶² It also depends how competitive Cambodia’s garment sector will be at the time when EVFTA takes effect, given that skills gap may be addressed by the recent establishment of the Cambodian Garment Training Institute.

Tariff elimination provided by the EVFTA for other competing products such as those under HS codes 6110, 6109, and 6203 (currently classified under Category B5 of the EU tariff schedule), which cover about three-quarters of Cambodia’s exports to the EU market, will be removed within a seven-year period after the free trade agreement takes effect.⁶³ According to the existing EU tariff schedule, the tariff reduction for

⁵⁸ Cambodia’s total exports are projected to be US\$ 6.9 billion in 2016. The EU and the US markets account for 40 percent (or US\$2.8 billion) and 30 percent (or US\$2.0 billion), respectively

⁵⁹ Products are considered originating under the agreement if they meet one of the following requirements: (i) wholly obtained in Vietnam; or (ii) products produced in Vietnam incorporating materials which have not been wholly obtained there, provided that such materials have undergone sufficient working or processing within Vietnam. See <http://www.vietnam-briefing.com/news/eu-vietnam-fta-understanding-rules-origin.html/>

⁶⁰ See EU-Vietnam Free Trade Agreement: Agreed text as of January 2016, <http://trade.ec.europa.eu/doclib/press/index.cfm?id=1437>

⁶¹ Arbitrarily assuming that only half of export value of the impacted products may be drop due to Vietnam’s duty free access to the EU market upon ratifying the free trade agreement. Everything else being equal, this will shave off about 1.5-1.8 percentage points from the real growth. However, it may not happen within one year because order and supply responses lag (even though those tariff lines will be immediately zero).

⁶² See Box I.B.2. Cambodia’s Garment Sector, October 2016 East Asia and Pacific Economic Update, the World Bank Group

⁶³ The EU will also eliminate duties with longer staging periods (up to 7 years) for some sensitive products, especially in the textile apparel and footwear sectors. The elimination of duties, however, will not be an open door for Chinese products to flood the EU market: to benefit from the preferential access, the strict rules

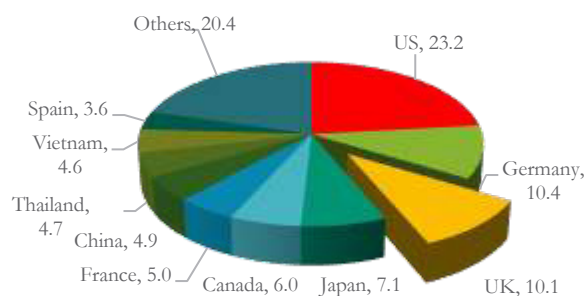
these products will be implemented in six equal annual stages.⁶⁴ This will likely allow the garment industry in Cambodia to adjust.⁶⁵

b. Brexit

While the United Kingdom (UK) is Cambodia's third largest trading partner in the world, after the US and Germany, it absorbs only 10 percent (or US\$800 million) of Cambodia's exports (Figure S10).⁶⁶ The UK market therefore accounts for about 28 percent of Cambodia's exports to the EU. Of the total exports to the UK, garment and footwear exports account for 76 percent (or US\$600 million) and 17 percent (US\$200 million), respectively.⁶⁷ While it is clear that Cambodia will likely lose some garment (and footwear) market share in the UK market (perhaps to Vietnam), if the UK after leaving the EU, fails to grant Cambodia duty free access to its market (as it currently does as part of the EU's EBA preferential treatment), it is likely that the negative impacts on Cambodia's garment (and footwear) exports are likely to be insignificant.

Let's assume that without duty free access to the UK market, Cambodia's garment exports to the UK could drop by 12 percent or US\$70 million. In this case, real growth could potentially decline by about 0.3 percentage point (or about 0.4 percentage point, if potential negative impacts on footwear exports are included).

Figure S10: Cambodia's merchandise exports to top 10 countries, percent share



Source: UN COMTRADE

In addition, the World Trade Organization's (WTO) most-favored-nation (MFN) principle requires equal treatment and countries cannot normally discriminate between their trading partners (some exceptions, however, are allowed; for example, countries can set up a free trade agreement that applies only to goods traded within the group — discriminating against goods from outside).⁶⁸ Bangladesh, Cambodia, Lao PDR, Myanmar and Vietnam are all members of the WTO and all but Vietnam are beneficiaries of EBA preferential treatment.⁶⁹ Without any free trade agreements with the UK, these countries will have to compete with each other on an equal footing for the UK market. In this case, potential export gains by Vietnam under EVFTA will also decline.

c. Trans-Pacific Partnership

The Trans-Pacific Partnership (TPP) will place Cambodia at a disadvantage vis-à-vis Vietnam, if ratified. TPP will allow Vietnam to obtain preferential treatment for its exports to TPP members, in particular the US (and Canadian) market, accounting for about US\$ 2.0 billion (or 30 percent of total garment exports) which is currently the second largest market for Cambodia's garment exports, after the EU market.⁷⁰

of origin for garments will require the use of fabrics produced in Vietnam, with the only exception being of fabrics produced in South Korea, another FTA partner of the EU. See http://europa.eu/rapid/press-release_MEMO-15-5468_en.htm

⁶⁴ For detailed EU tariff schedule, see http://trade.ec.europa.eu/doclib/docs/2016/february/tradoc_154200.pdf

⁶⁵ The EU-Vietnam Free Trade Agreement is reportedly on the course of being legally reviewed before ratification and the entry into force of the Agreement is tentatively foreseen in 2018. See http://www.ambhanoi.esteri.it/ambasciata_hanoi/en/ambasciata/news/dall_ambasciata/2016/06/accordo-di-libero-scambio-eu-vietnam.html

⁶⁶ US\$ 800 million is based on the Balance of Payments data

⁶⁷ The percentage share follows UN COMTRADE statistics while the nominal merchandise trade data are from the National Bank of Cambodia (as UN COMTRADE statistics provide larger nominal trade data).

⁶⁸ Principles of the trading system, WTO. See https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm

⁶⁹ See https://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm

⁷⁰ For more detailed info on TPP, see <https://ustr.gov/tpp/>

While rules of origin and safeguards will still apply,⁷¹ the tariff schedule of the US allows for immediate elimination for most of the tariff lines, ranging from 0.9 percent to 28.2 percent, for the HS codes representing Cambodia's top ten garment products shown in Table S5.⁷² Unlike under the EVFTA which only about US\$700 million of garment exports value will be immediately hit, the TPP will affect almost the entire Cambodia's garment exports to the US market at once when TPP takes effect. The potential negative impacts will be even greater, if the Canadian market is included. The TPP therefore presents a more challenging threat to Cambodia's garment industry (and growth) than the EVFTA.

Again, potential negative impacts on Cambodia's garment exports may not fully materialize soon after the TPP takes effect due to similar factors discussed in under the EVFTA above. An additional factor for the US market is safeguards which may help protect the US market against a sudden surge in garment exports from Vietnam. The safeguards may therefore provide Cambodia's garment industry time to adjust.

V. Conclusion

Given the "footloose" characteristics of its garment industry together with the existing ownership structure whereby there are only a handful of domestic investors, garment factories can be relocated relatively quickly from Cambodia to more attractive countries, if they face a squeeze in profit margins due to rising input costs, higher taxes, less favorable preferential trade treatment, or an economic slowdown in key export markets. Promoting local participation in the garment industry will therefore be important including encouraging more supporting industries to the garment sector from locally-owned small and medium-sized enterprises. Promoting joint ventures and partnerships between domestic and foreign investors may also be a way forward.

There are significant risks of investment and export diversion away from Cambodia unless key constraints, such as high energy and transportation costs and infrastructure bottlenecks are successfully addressed. This will require more attention and facilitation from the public sector.⁷³ The garment industry is exposed to increasing competition from Vietnam which has also developed upstream in the sector together with emerging competition from Myanmar which is opening up to foreign investment.

Given potentially large negative impacts of the EVFTA and severe consequences of TPP on Cambodia's garment exports, it will be important to devise a concrete plan to improve competitiveness and diversifying export sectors. Structural reforms to make Cambodia's tradeable sector more competitive is core to improving competitiveness of the economy. Current investment which is heavily concentrated in the non-tradeable sectors, namely the construction and real estate sectors may not bode well for Cambodia's future economic success and policy support could encourage the tradeable sectors to be further strengthened to become more competitive.

One further policy option may therefore be oriented towards boosting high value-added garment products by encouraging the garment industry to gradually add value to its products and to vertically integrate to the extent possible. This may also lead to diversification beyond garments as envisaged under the 2015-25 Industrial Development Policy. It is also important to further strengthen and deepen dialog and consultation under public-private sector forums to continue to foster the sector.

⁷¹ For detailed rules of origin, see <https://medium.com/the-trans-pacific-partnership/textiles-and-apparel-9612f6bd809e#.r2mb5jx5s>

⁷² <https://ustr.gov/sites/default/files/TPP-Final-Text-US-Tariff-Elimination-Schedule.pdf>

⁷³ GMAC has reported that its membership is stagnant, suggesting that it is possible that additional investment has slowed.

While the garment sector contributes substantially to real growth, it only generates a modest number of jobs. An important economic policy aimed at creating jobs to absorb a rising number of entrants into the labor force of about 160,000 a year will need to focus on other sectors as well, especially the agriculture sector, given that the majority (70 percent) of the population resides in rural areas. While real growth remains robust, the recent structural transformation has resulted in a steady decline in employment growth, which dropped to 2.1 percent during the period 2009-15, down from 3.7 percent during period 1995-2000 while Cambodia's working age population (15-64 years) continue to increase, growing at an average rate of 2.6 percent per year during the period 2009-14.

It will be important to maintain good industrial relations and avoid the disruption of production and exports. Past experience has shown the costs and negative impact on investor confidence of poor industrial relations and all related parties, namely garment workers, unions and factory owners appear to have better understanding of the importance of the garment industry and their mutual interests, as well as the challenges and constraints the industry faces and all are now working more effectively together to overcome them. Addressing labor issues promptly and at their root cause may be the way forward. Education and awareness programs on important topics such as the Labor Law, corporate social responsibility, macroeconomic conditions, and the roles and responsibilities of unions and workers may also help to promote a better understanding and improved industrial relations going forward.

Cambodia: Key Indicators

	2012	2013	2014	2015	2016p	2017f	2018f
Output, Domestic Demand and Prices							
Real GDP (% change yoy)	7.3	7.4	7.1	7.0	7.0	6.9	6.9
Domestic demand (% change yoy)	9.9	11.3	10.1	8.5	9.2	10.0	10.0
Consumer price index (annual avg, % change yoy)	1.4	2.2	1.7	1.3	3.2	3.4	3.5
Public Sector (% of GDP)							
Government revenues	15.7	15.1	18.1	18.5	18.8	18.2	18.1
Government expenditures	21.6	21.5	21.6	20.5	21.7	23.2	22.9
Government balance excluding grants	-6.1	-6.6	-3.8	-2.0	-2.8	-5.0	-4.8
Government balance including grants	-3.4	-2.7	-1.4	-0.1	-1.2	-3.4	-3.4
Foreign Trade, BOP and External Debt							
Trade balance (US\$ millions)	-1,698.0	2,001.6	2,004.4	-2,333.2	-2,432.0	-2,622.6	-2,758.0
Exports of goods (US\$ millions)	5,839.0	6,886.0	7,636.0	8,208.8	9,017.7	9,936.7	10,877.2
(% change yoy)	7.9	17.9	10.9	7.5	9.9	10.2	9.5
Key export (% change yoy) 1/	7.0	17.6	11.7	14.5	12.0	11.5	10.8
Imports of goods (US\$ millions)	7,537.0	8,887.6	9,640.4	10,542.0	11,449.6	12,559.3	13,635.2
(% change yoy)	20.6	17.9	8.5	9.4	8.6	9.7	8.6
Current account balance (US\$ millions) 2/	-1,063.7	1,753.5	1,840.3	-1,908.4	-2,039.1	-2,219.1	-2,453.0
(% GDP)	-7.6	-11.5	-11.0	-10.6	-10.2	-10.1	-10.1
Foreign direct investment (US\$ millions)	1,698.0	1,826.2	1,676.6	1,654.4	1,700.8	1,799.1	1,697.1
External debt (US\$ millions)	4,547.4	4,925.8	5,363.1	5,715.4	6,306.7	6,993.3	7,764.0
(% GDP)	32.4	32.3	32.0	31.6	31.6	31.7	31.9
Debt service ratio (% exports of g&s)	1.0	1.2	1.4	1.5	1.6	1.9	2.1
Foreign exchange reserves, gross (US\$ millions)	3,463.0	3,642.5	4,657.9	5,672.1	6,778.2	7,557.6	8,203.8
(prospective months of imports of g&s)	4.3	4.1	4.9	5.4	5.3	5.6	5.7
Financial Markets							
Domestic credit (% change yoy)	29.6	28.6	28.4	27.0	25.8	23.0	20.0
Short-term interest rate (% p.a.)	11.6	11.3	11.5	11.7	12.0	11.8	11.5
Exchange rate (Riel/US\$, annual average)	4,033.0	4,027.0	4,038.0	4,060.0	4,058.0	4,062.0	4,067.0
Real effective exchange rate (2010=100)	105.4	109.9	113.1	119.8	121.8	124.3	127.4
(% change yoy)	0.5	4.3	2.0	1.3	1.7	2.0	2.5
Memo: Nominal GDP (US\$ millions)	14,038	15,245	16,776	18,084.4	19,971.2	22,042.9	24,360.0

Sources: National data sources, IMF, and World Bank staff estimates

f = forecast

p = projection

1/ Garments

2/ Excluding official transfers.



The World Bank
Cambodia Country Office
113 Norodom Blvd.,
Phnom Penh, Cambodia
Tel: (855-23) 861 300
Fax: (855-23) 861 301/302
Website: www.worldbank.org/cambodia