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Country Economic Report 2005:2

Cambodia – Ready for an Economic Take-off?

Foreword

This study on Cambodia is part of a series of annual studies, undertaken by various Swedish universities and academic research institutes in collaboration with Sida. The main purpose of these studies is to enhance our knowledge and understanding of current economic development processes and challenges in Sweden's main partner countries for development co-operation. it is also hoped that they will have a broader academic interest and that the collaboration will serve to strenghen the Swedish academic resource base in the field of development economics.

This report has been prepared by Örjan Sjöberg and Fredrik Sjöholm at Stockholm School of Economics. It explores the preconditions for and obstacles to enhanced sustainable economic development in Cambodia and identifies key elements for a strategy towards this end.

Per Ronnås
Chief Economist

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Content

Introduction[1]

Following decades of war and terror, since the early 1990s Cambodia has in many respects positioned itself on a positive development path. Yet, just as the situation at the start of the transition in 1991 was extremely troublesome, by and large the situation remains troublesome today after more than one decade of transition. More precisely, the country has one of the lowest levels of income in Southeast Asia and widespread illiteracy, malnutrition, and diseases are leaving a large share of the population in severe poverty. Still more disturbing, the situation has shown relatively little improvement over the past few years: income levels are increasing in the main urban centres but are stagnant in the rural areas; child mortality is not only alarmingly high but increasing; famines continues to be a real threat for large shares of the population. It is therefore widely thought that Cambodia's development has been disappointing, not least considering that three billion US dollars of foreign aid has flown in to the country over the last decade.[2]

The question is if and how economic development of Cambodia can be achieved? On a positive note, it might be argued that the foundation for an economic take-off is in place in Cambodia. For instance, the country is relatively open to international trade and investments; it is integrated with the region through the Asean Free Trade Area (AFTA) and with the world through the WTO preparations; there are no state owned enterprises that act as an obstacle for economic reforms and development; and there is an ample supply of cheap labour that could provide the basis for a competitive industry.

An economic take-off of Cambodia would arguable have to rest on two pillars. Firstly, improvements in agriculture productivity is necessary, both to lift the bulk of the population out of poverty, and for agriculture to provide linkages to other sectors of the economy. Secondly, expansion of industrial production is necessary if Cambodia's large supply of labour is to be absorbed into productive activities.

This paper examines the possibility of a development along this line of agriculture and industrial expansion. We note that there is, unfortunately, much to ask for in terms of policy improvements in the agriculture sector. More precisely, agricultural expansion is constrained by lack

[1] We are grateful for valuable comments and suggestions from Claes Leijon, Sok Narom, Wing Thye Woo, and participants at a Sida seminar in February 2005. The views expressed in the paper are the authors' and not necessarily those of Sida.

[2] See e.g. Phnom Penh Post, December 17–30, 2004, and IMF (2004d).

of inputs, poor infrastructure, and lack of recorded and well defined land rights. At the same time, the industrial sector will face large problems over the next few years as a consequence of the phasing out of the multi-fibre agreement (MFA) and China's entry in to the WTO. Garments are not likely to continue its role as an engine of growth and there are poor conditions for other industrial activities to expand: corruption and bureaucratic obstacles increase costs of production in comparison with other competing countries. Moreover, wages are relatively high in comparison to the low level of skill and productivity of the workforce.

The rest of the paper is organised as follows. We start with a description of the political turmoil over the last one and a half years. We then continue with an overview of the macro-economic situation, which is relatively stable but with some worrying future prospects. The analysis continues with a discussion of a possible development strategy for Cambodia, which emphasise the importance of agriculture development and industrial expansion. The prospects for such developments are considered in the next two sections and the paper ends with some concluding remarks.

Political Turmoil

In discussing recent political development in Cambodia it might be useful to keep the country's turbulent past in mind. The democratic transition started as late as in 1991, and the last groups of Khmer Rouge did not put down their weapons until the late 1990s. Hence, the political development in Cambodia over the past decade and a half has been positive: after decades of totalitarian rule the country has developed a pluralistic political system with parliamentary elections that are described by outside observers as reasonably free. Moreover, NGOs and trade unions are present and so is a free media.

Despite this positive development, substantial political problems remain and Freedom House, an international watchdog on civil liberties and political rights, classify the country as "Not Free".[3] The presence of many key democratic institutions notwithstanding, Cambodian rule is still largely based on patronage, and with little accountability of the government (Gottesman, 2002). It might even be argued that the high dependence on foreign aid, and therefore Cambodia's need to please foreign donors, is the main reason for continued existence of political opposition and lively NGOs (Marston, 2002). Moreover, although many of the democratic institutions might be in place they are often poorly managed, the legal system being a particularly sad example of an institution failing to implement its objectives.

Cambodia also continues to be plagued by political violence and politically motivated killings remains a serious and real threat to people engaged in social and political issues (Cambodia Daily, June 18, 2004; January 31, 2005). The killings seem to primarily target trade union leaders and politicians from the opposition. Very few arrests have been made which makes it uncertain who is behind the violence, but the police and military forces are believed by many observers to at least carry out the killings.

Although Cambodia has a free and relatively outspoken press, television broadcasting is dominated by the ruling Cambodia's People's Party (CPP). This is a severe constraint on the opposition's potential to reach out to the electorate since broadcasting is the main information channel for broad segments of the population. Printed media, widely available in the main cities, is of little consequence in rural areas where high illiteracy rates and logistic problems limit their circulation and hence impact.

[3] See www.freedomhouse.org

A peculiar yet serious political problem in Cambodia was the inability to form a government following the elections in July 2003. Negotiations were undertaken between the largest political party, the CPP, and the two main opposition parties, FUNCINPEC and the Sam Rainsy Party.[4] The need for a coalition might seem surprising considering the CPP's majority share of the votes in the 2003 election, but the reason is the two-third majority of the parliamentary seats that are required by the constitution to form a government. This amendment to the constitution was introduced after the 1993 election at the initiative of the CPP to balance the power of the at time largest political party, the FUNCINPEC. Ironically, the constitution is now working against CPP.

Although the CPP won the election convincingly, increasing its share of the electorate compared to the 1998 election, the two opposition parties put forward considerable request to be met if they should join a coalition government. For instance, both parties required that Hun Sen was to step down as Prime Minister, a request that was quite naturally turned down by the CPP (Than, 2004). There are two main reasons why it seemed so difficult for the opposition parties to join a coalition. Firstly, FUNCINPEC performed poorly at the ballots and worried that they would loose further support if they choose to continue to cooperate with the CPP. Secondly, FUNCINPEC claimed that they had very little influence in the previous government where they also formed a coalition with the CPP. Although they got a few ministerial portfolios, the power and implementation of policies was effectively controlled by the CPP.

Cambodia's political deadlock resulted in major problems. Apart from the embarrassment of not being able to form a government for eleven months after the election, there were serious economic consequences. Firstly, foreign donors such as the World Bank and the Asian Development Bank did not initiate any new projects until the political situation was solved. As a result, as existing projects ended and no new ones started, the amount of projects went down substantially in 2004. Budget support by various donors was also stopped with severe resulting problems for the public budget. Secondly, the WTO agreement needed to be ratified by Parliament. This was not possible in the absence of a government, which brought uncertainty to Cambodia's future trade regime.[5] There was also a need to discuss and prepare for the consequences of the WTO agreement, and of the phasing out of the MFA. No such preparations took place due to the uncertain political situation.

Finally, in June 26, eleven months after the election, Prime Minister Hun Sen from CPP and Prince Norodom Ranariddh from FUNCINPEC brought an end to the stalemate and formed a coalition government. The move enabled the National Assembly to approve the WTO accession on August 31; one decade after the application process began. The Khmer Rouge trial was also approved, although the issue on how this is going to be financed waits to be solved.

The formation of a government ended the political deadlock but not the political turmoil and problems. For instance, the new government consists of no less than 329 cabinet posts, including seven Deputy Prime Ministers, and 5 Senior Ministers. Moreover, each Ministry will have at least five Secretaries of State and five Undersecretaries of State. The result is an extremely cumbersome organisation, which is not likely to pursue its tasks in an efficient manner. Another consequence is that the

[4] FUNCINPEC – National United Front for and Independent, Neutral, Peaceful and Co-operative Cambodia.

[5] Similarly, the agreement on trials of former Khmer Rouge leaders was signed in June 2003 but needed ratification by the National Assembly. The failure to do so created resentment within and outside of Cambodia.

real political power is likely to remain in the hands of Prime Minister Hun Sen and a few of his closest allies within the CPP.[6] What is also worrying is that the new government has still not shown any commitment to prepare Cambodia for the end of the MFA. Again, Cambodia is very dependent on textiles: export of garments constitutes around 90 percent of total export, which is the highest concentration in the world after Lesotho.

The formation of a government did also mark the start of increased harassment of the political opposition, the Sam Rainsy Party. The opposition leader, Sam Rainsy himself, was accused of defamation, after claiming that Prince Ranariddh accepted a $30 million payoff from Prime Minister Hun Sen to form a government, and forced to temporarily flee the country (Phnom Penh Post, October 22 – November 4, 2004). Moreover, more than 40 Sam Rainsy Party members were accused to be members of a rebel militia intent on overthrowing the government, an accusation that international organisations such as Human Rights Watch and Amnesty International have questioned. Sam Rainsy parliamentarians have also been excluded from the nine assembly commissions, which might remove any checks and balances on the government. Finally, King Norodom Sihanouk, who carries substantial political weight in Cambodia, expressed great concern over the political development and refused to go back to Cambodia from his self-imposed exile in North Korea, until he abdicated in October and was succeeded by his son Prince Norodom Sihamoni.

[6] Prime Minister Hun Sen has according to some observers also strengthened his position within the CPP and marginalized his main competitor, Chea Sim, who was presumably forced out of the country during the formation of the government (Phnom Penh Post, July 16–29, 2004). Others believe that Chea Sim's departure to Thailand was voluntary and part of a scheme to involve FUNCINPEC in the government and to please the opinion of the previous King Sihanouk.

The Macro-economy

Economic Growth

In a number of policy documents Cambodia has stated the goal of an economic growth rate in the range of 6–7 per cent, an ambitious target that the country has, on average, been able to achieve during the last few years. Considering the relatively low income and level of development in Cambodia, and therefore the large demand for investment in physical and human capital, it is reasonable to assume that such growth rates would be possible to sustain for a relatively long period. However, as seen in Table 1, there is an indication that growth may have begun slowing down in recent years. More precisely, GDP growth has been falling every year since 1999. Growth in 2003 was relatively low despite a very high growth in the important agriculture sector. The main reasons were a SARS related drop in tourism together with election related uncertainties and reluctance of foreign textile producers to expand production as the phasing out of the MFA was approaching. The high fertility rate and thereby a high population growth of about 1.8 per cent implies that growth in GDP per capita has been around3 per cent in recent years.

Table 1. Key Macroeconomic Indicators (1997–2004)

	1997	1998	1999	2000	2001	2002	2003	2004 (pred.)
Real GDP growth (%)	6.8	3.7	10.8	7.0	5.7	5.5	5.2	4.3
Agriculture	6.4	5.8	3.4	–1.5	2.2	–2.7	9.2	––
Industry	19.6	–2.5	19.3	30.7	12.9	17.7	6.7	––
Services	3.4	4.8	10.9	5.7	4.2	4.5	1.6	––
Inflation (%)	9.2	13.3	–0.5	–0.8	0.7	3.7	0.5	3.2
Government Budget (% of GDP)								
Revenue	8.9	8.1	10.2	10.4	10.7	11.2	10.4	11.9
Expenditures	12.7	13.5	14.1	15.3	16.3	17.8	17.4	18.0
Balance (incl. grants)	–0.4	–2.5	–1.3	–2.1	–2.8	–3.8	–4.5	–3.8
Balance of Payment	–	––	––	––	––	––	––	––
Exports (millions US $)	–	––	997	1,283	1,462	1,638	1,960	2,117
Imports (millions US $)	––	––	1,490	1,849	2,010	2,228	2,524	2,836
Current account (% GDP)	–7.4	–12.4	–13.2	–11.7	–9.4	–9.0	–10.2	–10.8

Source: IMF (2004b; 2004c).

By early 2004 the Cambodian economy was predicted to grow at about 4.3 per cent. Hence, the trend of lower growth rates might continue. However, the prediction is highly uncertain and there are other more pessimistic, as well as more optimistic, predictions.[7]

The political deadlock between June 2003 and June 2004 had a substantial negative effect on inflows of foreign aid, both in terms of development projects and in terms of budget support. Considering the large importance of foreign aid for the Cambodian economy, about 18 of GDP in 2003, the result might have bee severe on the growth rate for 2004. For instance, the government had fewer resources for civil service salaries and other expenditures, which today amount to more than 20 per cent of total public expenditure. Such lack of public resources have a strong negative impact on the public sector's ability to carry out its tasks. Moreover, decreased expenditures on health, education, and infrastructure will also negatively affect economic growth, although the effect might not be immediately visible.

Moreover, agricultural output boomed in 2003. However, due to little rainfall in the last quarter of 2003, harvests are expected to have been smaller in 2004. Hence, agricultural output will presumably not have grown to the extent it did in 2003, but might even have been falling.[8]

Thirdly, the manufacturing sector has had a high growth rate over the last few years, largely thanks to strong expansion of garments. This might not have continued in 2004, because of the phasing out of the Multi-fibre Agreement.

On the positive side, tourism seems to have been growing faster than previously expected. It is likely that the growth in number of foreign visitors reaches around a surprisingly high 40 percent in 2004, which will give a boost to the whole service sector and to the economy as a whole. This development contrasts last years difficulties in the tourism sector after the anti Thai demonstrations in 2003 and due to other factors such as SARS, bird flu, and competition from other tourist destinations in the region.

Inflation

Cambodia's economy is highly dollarized. This brings some potential benefits in terms of some protection from exchange rate risks, deepening of the financial market, economic and financial integration with the outside world, and improved fiscal discipline (de Zamaróczy and Sa, 2003, pp.17–19). This should be balanced against the negative effect of losing control of the base money supply and therefore the ability to control inflation. Fortunately, inflation has been relatively low for the past few years. For instance, inflation was negative in 1999–2000 and less than one per cent in 2001. Inflation has since increased but is still well below four per cent annually over the period 2002–2004. Moreover, inflation has been relatively low despite falling interest rates in recent years. However, interest rates still remain substantially above interest rates in neighbouring countries: interest rates on lending in foreign currencies in 2002 were about 16 per cent in Cambodia, 9 per cent in Vietnam and 7 per cent in Thailand (CDRI, 2003, p.22).

The main reasons for relatively low inflation rates in recent years are falling food prices, due to improvements in the agriculture sector together with increased marketisation of food products (CDRI, 2003). Such im-

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[7] IMF (2004a) suggests that the economic growth in 2004–05 might slow down to about 2 per cent. EIC (2004, p.5), on the other hand, expects growth to increase to about 7 percent in 2004 and then fall to about 3.5 percent in 2005.

[8] The lack of rain since mid-October 2004 is likely to jeopardise the main rice harvest also in 2005.

provements are important since food constitute an overwhelming share of the consumption basket. Prices on housing and transport have, on the other hand, increased quite rapidly, driven by strong demand. There is a risk that inflation will be higher than the predicted rate of 2.9 per cent in 2004, mainly due to large increases in oil prices.

Public Budget

Cambodia has a budget deficit of about six per cent of GDP, a level which has been maintained for a number of years. Part of the deficit is financed through foreign grants, which currently brings down the remaining deficit to about 3.8 per cent of GDP. The main reason to the budget deficit is low revenues: revenues only amount to between 10–12 per cent of GDP over the period 1999–2004. Taxes account for about 70 per cent of total revenues, the most important ones being VAT and trade taxes. The remaining part of government income comes mainly from quota auctions and from various licenses and royalties. The phasing out of the MFA is going to substantially decrease revenues from such quota auctions with approximately USD 30 millions.

Hence, public revenues are low and need to increase both to balance the budget and to facilitate increased expenditures on development related areas such as education, health and infrastructure. As can be gauged from the increased revenues in 2004, some progress has been made. However, revenues are still low compared to many other developing countries. In fact, public revenues in Cambodia today are lower than in the 1960s when tax revenues alone amounted to about 15 per cent of GDP (MEF, 2004, p. 74). Improvements in the legal system, increased salaries of tax officials, decreased opportunities to exercise personal discretion, and simplification of tax structures, are some of the necessary reforms that are needed.

Balance of Payment

Exports and imports have both grown with double digit figures over the last few years: exports increased from 19 per cent of GDP in 1997 to about 47 per cent in 2003 and imports increased from about 31 per cent to about 60 per cent. Hence, despite a strong expansion of exports, primarily of garments, imports tend to grow at a similar or higher pace resulting in a large current account deficit. Most of the deficit is covered through official transfers, bringing down the remaining deficit to about 2–3 per cent of GDP. It should be noted that the figures only captures registered trade. A large share of imports and export is smuggled over the long borders to Thailand and Vietnam and the real trade balance is difficult to estimate. Still, the figures might suggest that any decrease in official transfers could put the country at the risk of a balance of payment crisis. Foreign exchange reserves amounts to about 633 millions of US dollars, or about three months worth of imports of goods and services.

A Balanced Growth Approach to Future Development

As seen from the previous discussion, progress has been made in Cambodia but there are also large remaining economic problems. Together with Myanmar and Laos, Cambodia ranks as the poorest country in the region (Table 2). Moreover, the inequality within Cambodia is large and most people depend on subsistence farming with low and volatile incomes. Dependence on food aid prevails in Cambodia when weather conditions are unfavourable.[9] Data on socio-economic conditions in Cambodia is relatively fragmented but the situation seems very worrying and there is little evidence of any improvement in overall living conditions. For instance, UNDP reports in its Human Development Report that about one-third of the population live below the poverty line, a figure that is substantially higher than in other South-east Asian countries and only a small decrease from the 39 per cent in 1994. Other studies suggest that poverty has increased over the period 1999–2003. For instance, a recent study by the World Bank estimates that about 45.5 percent of the population was considered poor in 2003, up from 41.5 percent in 1999.[10] Accordingly, IMF (2004d, p.34) report an increase in poverty from around 37 percent of the population in 1996 to about 42 percent in 2002. IMF also notes that this development is in stark contrast to the development in China Lao and Vietnam where poverty has been halved since 1990. Moreover, regional inequality seems to increase. Whereas Phnom Penh and its surrounding have benefited from the emergence of a formal economy, most other parts of the country have been left out of the development process: the average household expenditure in the rural area has declined from 33 per cent of that in Phnom Penh in 1993 to about 25 per cent in 2002 (IMF, 2004c, p. 5).

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9 For instance, the United Nations started delivering emergency food aid to drought victims in southern Cambodia in October 2004.

10 Cited from EIC (2004, p.39)

Table 2. Development Indicators for Cambodia and Other Countries (2002).

Country	GDP per capita (PPP US$)	Population living on below $1 (PPP) a day	Life expectancy at birth (years)	Under-five mortality rate (per 1,000 live births)
Malaysia	9,120	<2	73.0	8
Thailand	7,010	<2	69.1	28
Philippines	4,170	14.6	69.8	38
Indonesia	3,230	7.5	66.6	45
Vietnam	2,300	17.7	69.0	39
Cambodia	2,060	34.1	57.4	138
Lao	1,720	26.3	54.3	100
Myanmar	––	––	57.2	109
All developing countries	4,054	––	64.6	89

Source: UNDP. Human Development Reports. www.hdr.undp.org

Poverty also translates into low life expectancy and high child mortality. Child mortality is higher than in other countries in the region and is actually reported to have increased over the past ten years, mainly through sharp increases in diseases such as acute respiratory infections and measles (IMF, 2004c, Box 1; IMF, 2004e, p.89). At about 437 per 100,000 live births the maternal mortality rate also remains extremely high (IMF, 2004c, p. 6). Hence, it comes as no surprise to learn that Cambodia is ranked 130th out of 173 countries according to the Human Development Index in 2002 (UNDP, 2004, p.141). Moreover, the situation is showing only very slow progress and Cambodia is not likely to meet the Millennium Development Goals.

Yet, although substantial problems thus persist, one might argue that the foundations for growth are in place. This is so as the past decade's political and economic reforms and increased stability represent a decisive step forward. Stability is of course crucial in achieving future economic development, but the question is how this development could be achieved? It seems plausible that the development has to rest on two pillars: improvements in agriculture and expansion of manufacturing production.

Development in a highly agrarian economy, dominated by subsistence production and a large pool of unemployed or under-employed labour – yielding, in effect, zero marginal productivity in agriculture – presupposes a shift out of agriculture and hence makes the ability of the non-agricultural sector to absorb labour the critical factor. To the extent that the non-agricultural sector is able to do that, productivity levels will eventually start to increase also in agricultural production. Such productivity increases in agriculture are important to lift broad segments of the population out of poverty. As this happens, the expanding non-agricultural sector will also increase its demand for agricultural produce – there are, after all, fewer subsistence farmers around as a result of this shift of labour out of agriculture – thereby contributing to a virtuous circle.

What is more, or so the argument goes, increased demand – possibly as combined with other sources of income for the agricultural household – will open up an opportunity for specialisation. As long as subsistence agriculture predominates, risk minimisation and a need to cater to a varied crop for on-farm consumption are likely to prevail. Although rational to the individual household, it is not likely to improve productivity or turn agriculture into a thriving part of the economy. This is so as gains from specialisation will not come about. If subsistence needs prevail, the ability to foot the bill for improved inputs will be severely constrained and any marketable surplus to result from farming activities is likely to go on the market at about the same time as everyone else has a marketable surplus, thereby depressing the prices fetched by the individual household. Although households do need a measure of cash income to meet various obligations (e.g., taxes) and to purchase essential goods not possible to produce on-farm, if market production is limited to this minimum – as is indeed likely due to the restrictions imposed by risk minimisation and on-farm consumption needs – continuing low returns to market activities are unlikely to help sway producers away from subsistence activities. Instead, a negative spiral will set in, in particular so if population pressure on the land increases as a result of high levels of natural growth.

Much of this appears relevant to Cambodia. Around 80 per cent of the population, and 90 per cent of the poor, live in rural areas; they are largely dependent on agriculture. Hence, improvements in agriculture will have a large impact on the welfare of large segments of the Cambodian population. As was noted above, areas close to major urban centres have seen some success in increasing the volume of marketed produce. However, it can be argued that such improvements are necessary but not sufficient for a sustainable economic development. This is so precisely because Cambodia is a country characterised by substantial labour surplus or, in other words, under-employment of its labour force. The problem is aggravated by rapid population growth. Cambodia has a very young population; about 43 per cent of the population is below 15 years old (National Institute of Statistics, 2003, Table 2). As a result, the labour force increases at a rate of more than 200,000 people every year. However, only about 20,000 new jobs are created annually in the formal market. Most of these new entrants to the labour force have to make a meagre existence out of subsistence agriculture. As a result, the number of employees in agriculture has increased with close to 40 percent from 3.1 million people in 1993 to 4.3 million in 2002 (National Institute of Statistics, 2003). Output increased in the first half of the 1990s but has been more stagnant in recent years, which has resulted in declining labour productivity in agriculture since 1997 (CDRI, 2002).[11]

Due to limited absorptive capacity and other factors, any improvements in agricultural production techniques as might come about will not immediately solve the problem of under-employment. For instance, changes in farm technology, such as irrigation and use of fertilizers, will increase output but are not likely to create many new jobs. Previous experience suggests that new technology and employment are not necessarily complementary to any larger extent. Yet, as noted above, productivity growth in agriculture is also important to improve the general level of incomes and well-being in rural areas; expansion through intensified land use must not be allowed to replicate the phenomenon that anthropologist Clifford Geertz once identified as involution.

Rather, a substantial degree of job creation combined with the improvement of productivity levels in agriculture will require an expansion of industrial production. As also the experience from other developing

[11] An additional problem with lack of job creation in the formal sector is that it can be politically destabilising with a growing number of young people outside of the formal labour market.

countries suggests, the secondary sector might be best suited to absorb huge numbers of labour in a relatively short time-period. If so, and under ideal circumstances, industrialisation will not only help create jobs for the lucky few, but will reduce the level of under-employment in other sectors. Against this background it is easy to see why the newly installed government is keen to increase investments in labour intensive industry to bring about 'productive employment to absorb the inflow of surplus laborers from rural areas' (Royal Government of Cambodia, 2004, p. 38). What is more, with time this will help agriculture through improvements in productivity (fewer labour hands producing the same level of output), to which should be added the beneficial effect of increasing demand for agricultural produce from households outside agriculture, which in turn may provide possibilities and incentives to improve the technology employed.

Hence, a process of sustainable development in Cambodia seems to require both improvements in agriculture and an expansion of manufacturing production.[12] This is not an unusual development path. On the contrary, it is a path that has previously been attended by many other East Asian countries, most recently by China and Vietnam. An important question is if such development could be achieved also in Cambodia?

Table 3. Distribution of Labour Force (per cent of total labour force).

		Sector		
Country	**Year**	**Agriculture**	**Industry**	**Service**
Cambodia	2002	77	9	14
Soviet Union	1989	19(a)	38(b)	43
North Korea	1993	33	37	30
China	1978	71	15	14
Vietnam	1989	71	12	17

Source: Noland (2000) table 3.7. CDRI (2003) table 9.
Note: (a) Agriculture and forestry. (b) Industry and construction.

There are some conditions that indeed suggest that such a development path would be possible for Cambodia. The perhaps most important is the high share of the population that is employed in agriculture and the lack of a large inefficient state owned manufacturing sector. Table 3 shows the distribution of the labour force in a few transition economies. An overwhelming share of the Cambodian labour force is employed in agriculture. In 2002, about 77 per cent were employed in agriculture, 9 per cent in industry, and 14 per cent in the service sector. One important difference between countries such as China, Vietnam and Cambodia on the one hand, and the Soviet Union and North Korea on the other hand, is that the share of the labour force employed in industry at the start of transition was much larger in the latter group. There are large advantages for transition economies in having a relatively small share of their labour force engaged in the industry sector at initial stages of their transition (Woo, 1999). In transition economies with large state-owned enterprises sector, this sector needs to be dismantled in order to free up resources for the emerging private industry sector. Such changes

[12] This is not to say that for instance tourism cannot play a role in Cambodia's development. However, experiences from other countries in the region suggest that the industry sector is better placed to absorb a labour surplus and will therefore be relatively more important.

are always politically difficult to pursue. In transition economies with a large share of the labour force in agriculture, the transition tends to be smoother with a flow of resources from agriculture to the private industry sector. This is especially so if agriculture has been organised in the form of small production units and/or with a structure of production, infrastructure and sub-division of fields not primarily geared to the needs of technologies based on economies of scale. Moreover, Cambodia might in this respect be in a more favourable position than even China and Vietnam were at the start of their transition, since both these countries did have a state-owned sector that later has proven to be a constraint on their economic development. State-owned companies are for instance absorbing a large share of domestic capital in China and Vietnam, in turn crowding out private-sector investments and leading to unstable financial markets. Industry in Cambodia is privately owned: Cambodia does not have any state-owned companies with the exception of providers of energy and some other public utilities.

On the other hand, conditions in Cambodia differ from those in China in a very important respect. Due to the open nature of this small economy, increasing incomes in agriculture, to the extent that they come about, are less likely to feed into local demand of non-agricultural goods. Not only are foreign products more easily obtainable – distance and infrastructure posing less of an hurdle here than in much larger countries – but the cost of much local production of basic inputs and consumption goods is likely to be such that it will not be competitive. Any attempt to reduce competition from imports, while perhaps salutary for local suppliers in the short term, has the unattractive consequence of reducing the purchasing power of the agricultural and non-agricultural population alike. Besides, the newly gained WTO membership implies rather stringent requirements on this score.

Furthermore, as in Vietnam, specialisation within agriculture may not solve the problem. As statistics suggests that the overwhelming part of the land available to farmers is already devoted to rice (see below), it would be more relevant to speak of intensification than specialisation as a means of moving beyond subsistence agriculture and high levels of on-farm consumption relative sales. This is also the view of the current government, which sees intensification as a key to improving agricultural productivity (Royal Government of Cambodia 2004, p. 26). Intensification, however, is still more demanding with respect to inputs and may, despite a great need for labour to control weeds and pests, prove a non-viable strategy on grounds of sustainability. Intensifying production, with its increased input costs and therefore falling returns to additional output, and farmers who are dependent on the market may find it more worthwhile to either diversify or to move into subsidiary non-agricultural activities, only the former option of which is mentioned in the so called Rectangular strategy (and then at the village rather than farm level; Royal Government of Cambodia 2004, pp. 27–28). The choice is in part conditioned by the policies pursued by the government: if rice self-sufficiency is a national priority, efforts at diversification are likely to run up against considerable hurdles and a shift into other activities becoming all the more attractive – if only such options exist or can be developed.

Agriculture

As previously mentioned, roughly four-fifths of the workforce is employed in agriculture. Indeed, 90 per cent of the poor live in rural areas. Hence, progress in agriculture will have large effects on Cambodian welfare. Examining the agriculture sector in more detail in Table 4 we see that rice dominates, leaving only minor shares to cash crops such as maize, soybeans and vegetables. However, the share of rice is substantially larger in terms of land use than in value terms. More specifically, rice constitutes about 88 per cent of cultivated land but contributes only to about 54 percent of crop value, or 9 per cent of GDP. This confirms that most agriculture is subsistence farming with low yields. In fact, the majority of farmers cultivate no more than one hectare of rice.

Although Cambodia's soil, access to water and climate does not provide it with a unquestionable competitive advantage in agriculture production, there is a potential for expansion of a wide range of agricultural products. As yet, however, this potential has not been realised because of a number of constraints. The main problems for agriculture expansion seem to be lack of irrigation and fertilizers, while crop varieties and cropping systems are also not up to scratch. As one report recently put it, 'no significant improvement of rice production [has occurred] in Cambodia in 40 years' (Asia Pacific Biotech, 2003, p. 1201). Variation across years there is, but little by way of sustained long term expansion. Indeed, it appears that, despite efforts by donors and government agencies, farmers devote too little attention to growing cash crops. These problems are, in turn, partly caused by poor market access, widespread corruption in the supply chains, cross border trade barriers and insecurity of land tenure.

Table 4. Different Crops Share in Cambodian Agriculture in 2002 (%).

	Share of total cultivated area	**Share of total crop value**
Rice	88	54
Maize	6	3
Cassava	1	3
Sweet potato	<1	1
Vegetables	2	8
Mung bean	1	1
Peanuts	<1	<1
Soybeans	<1	2
Black and white sesame	<1	1
Sugar Cane	<1	1
Tobacco	<1	<1
Jute	<1	<1
Cotton	na	0
Other crops	na	24

Source: IMF (2004b); National Institute of Statistics (2003).
Note: total cultivated area refers to area cultivated for short-term crops. na – not available.

The poor market access is caused both by sub-standard infrastructure and by a poor marketing and distribution system. From this observation alone, improved physical access seems to be desirable. As improvements of, for instance, roads not only extend the number of farmers that could conceivably reach the market, but also increases the market area of existing urban areas and improves the feasibility of multiple job-holding in rural areas, there is much to be said for such investments. However, not even under the best of circumstances is it likely to solve all outstanding problems. For one thing, the attractiveness of produce still needs to be attended to. Consider the example of the tourist trade. Almost all larger hotels in Cambodia import their fruits and vegetables from Thailand and Vietnam despite a price that is three to five times higher than locally produced food. Uncertainties in delivery from local producers, together with quality problems, still make imports to be preferred. For another, any such expansion of the market economy is likely to be spatially uneven, with areas in close proximity to major urban centres the most likely to benefit not only in the short run (as is in fact already happening) but conceivably also over the long term. Only as the pressure on the land adjacent to urban areas builds up can outlying districts be expected to be drawn into any such process of growth – unless, of course, they could avail themselves of some other competitive advantage.

On the other hand, and despite higher output in leading producer countries such as Thailand and the US, increases in consumption worldwide has outstripped production increases each one of the past three years, resulting in rapidly increasing world market prices (by one-third or more in 2004 alone). As this is likely to continue also in 2004–2005, for a country like Cambodia where food security has been on top of the agenda, such developments are reason for concern and constraints to exports are, wittingly or not, in place. For instance, while the Government encourages the export of surplus grain, food security concerns translates into the need to obtain a license for exports. As a result, official revenues from rice exports are appallingly low. However, considerable amounts of produce finds its way across the border to neighbouring countries (in particular Thailand), thereby fuelling the fears about Cambodia's ability to feed itself. If anything, however, this shows that farmers may respond to demand, provided that their produce fetches a reasonable price and the marketing channels are in place. The loser for now is rather the state budget, as incomes earned from illegal or semi-legal export trade in rice are beyond the reach of the authorities.

Indeed, farmers will not invest in new production methods or in gaining market access or perhaps even not shift from subsistence farming to cash crop production unless they see clear economic benefits from such investments and changes – and then only if they are provided the means to do so. One major problem is that land rights are ill-defined, bringing pronounced uncertainty as to the economic rewards for long-term investments. The problem is partly due to the legacy left behind by the Khmer Rouge regime, as it abolished private property rights and destroyed all land maps, records of title deeds and other similar records (Cambodian Daily, June 17, 2004). A programme for allocating land rights to the farmers exists but the progress has been slow. So far only about 10 per cent of the farmers have well defined land rights. Hence, it seems important to speed up the process of defining such rights and to distribute title deeds, but the signs are not positive. In fact, as improvement of infrastructure and price liberalisation increase the return to land, there is a clear increase in cases were land is simply taken over by, mainly, public officials.[13] Unfortunately, not even in instances were there are defined land rights can the farmer be fully secure, since such rights do not seem to prevent the government from reselling the land to government officials. Complaints are seldom successfully brought to the judiciary system.

An additional problem with poorly defined land rights is the difficulties in financing improvements in farming methods. Farmers need collateral to get access to bank credit. Land rights can be used as such collateral. In their absence, the farmers are not likely to get loans from the formal financial sector. This is the main reason to the low use of fertilizers and means of pest control, which are relatively costly and often have to be imported from Vietnam. The lack of credit is also a major constraint on the ability of farmers to diversify to crops such as fruit trees, where the returns will not start until at least three years after the investment.

Industry

As previously mentioned, one advantage that Cambodia enjoys is the lack of an inefficient state owned industry sector of the sort found in, for instance, Vietnam and China. Moreover, there has been no, or very few, attempts by the ruling elite to build own business empires with the help of protection from domestic and foreign competition. This is in contrast to industrialisation in much of the rest of Southeast Asia, which is characterised by strong links between the political and business sphere. Typically this means that the political establishments throughout the region have large direct or indirect owner interests in the industry (MacIntyre 1994; Rodan et al. 1997). This does not appear to be the case in Cambodia, where corruption is a tremendous problem but where the political establishment seems to have their economic interests in forests and land ownership rather than in manufacturing.[14] As a result, there are fewer distortions in Cambodia's industrial policy compared to most other countries in the region, where politicians have an incentive to provide subsidies and protect industries where they have own pecuniary interests. Cambodia's membership in AFTA and the WTO will presumably ensure that that situation of relatively few domestic distortions will remain, since introduction of exclusive monopoly rights or high tariffs and other trade related barriers will then be difficult to pursue.

The garment sector is the only substantial manufacturing sector in Cambodia. Its development has been impressive over last few years; in 1995 it employed about 19,000 workers, which grew to about 235,000 in 2003. It is also estimated that the industry indirectly feed about 1 million rural lives through remittances (Samnang and Hach, 2003). Today garment constitutes around 90 per cent of total exports.

The unexpected success of Cambodian garment production started with the bilateral trade agreement with the US in 1996, which reduced the average US tariff from around 60 per cent to about 15 per cent. The industry has also benefited from export quotas under the MFA and also additional special and generous quotas from the US. The US accounts for about 70 per cent of Cambodia's total garment export. However, quotas are going to be phased out under the global liberalisation of the textile and garment sector. Moreover, China's and Vietnam's entry in to the WTO will further stiffen competition in the textile sector. Quite

[14] Hotels and casinos are other areas where the political elite has large personal interests.

naturally, there are concerns that this will have a severe negative impact on the industry. How negative the effect will be is open to debate. The government believes the effect to be modest since the adherence to core labour standards might support demand for made-in-Cambodian garments (IMF, 2004c, p. 15). However, a report by the Ministry of Economy and Finance (2004, p. 34) is more pessimistic and estimates that the effect of increased competition from China will decrease Cambodian exports of garments with between 10 to 30 per cent. IMF (2004c, p. 11) is also pessimistic on the future of Cambodian garments. They observe that Cambodia only manages to export to markets where it has special quotas, and is not able to compete with Chinese exporters in markets where no such quotas exist. To be able to compete without quotas require a cost reduction in the range of 15–30 per cent according to the IMF.

There are also other, more positive views on the future of Cambodian garments. For instance, most multinational producers of garments seem reluctant to concentrate all their production to one country. Recent events such as terrorism, SARS and bird flue have highlighted the benefit of diversifying production in the interest of reducing risk. Hence, it is likely that producers of garments will stay in Cambodia in the short run, which gives the country some time to address important policy issues and try to increase competitiveness. Moreover, there has been little attention given to the large textile industry that has emerged along the border to Thailand. This domestically owned industry is mainly located in Poi Pet and is said to consist of some hundred firms and employ several thousand employees. The textile mills are exclusively supplying the Thai market and hence are not a result of international quotas on garment production. The conclusion is that Cambodian garments and textiles might be able to continue to compete in some niche products and in some markets.

In sum, the exact magnitude of the impact of China's entry in to the WTO and the end of the MFA on Cambodia's garment sector is difficult to estimate. It does seem clear, however, that the sector will at least not act as an engine of growth over the coming years. The question what industries that might provide future growth is very difficult to answer, but it is likely that it will be in labour intensive and agro-based sectors. What seems important is for the government to lay the foundation for such an expansion. Official pronouncements suggest that the current government is aware of the need to encourage labour intensive manufacturing activities (Royal Government of Cambodia 2004). In other words, if the environment for industrial production is reasonable good in Cambodia, foreign investors and domestic entrepreneurs will start production. Unfortunately, not only did the political stalemate following the elections in 2003 imply a loss of valuable time, the conditions for industrial production are rather poor today and a host of improvements have to be made. The necessary reforms range from improvements in the judiciary and civil service, to better infrastructure and improved skills and productivity of the workforce. Some of the more challenging difficulties is described at some detail below.

Obstacles for Further Industrialisation

One of the main problems for a rapid industrialisation of Cambodia might be the poor level of education. The relatively low level of educational attainment in Cambodia has several explanations. Obviously, the dramatic political turmoil during the past few decades has had a severely negative effect on education.[15] Moreover, there has arguably never been any emphasis on education in Cambodia, which seems to make the country differ from for instance China and Vietnam (Ayres, 2000). The situation was alarming at the end of the 1990s after a long period of stagnating enrolment rates and low public expenditure on education. The government then launched the Education Sector Programme in 2000, which has increased public spending on education together with enrolment rates in primary education (MEF, 2003). As seen in Table 5, however, the situation remains troublesome. Almost one-third of the adults are illiterate, a figure that is higher than in most other countries in the region. There are also suggestions that the situation is even worse and that about half of those who are considered to be literate do not read or write correctly.[16] Moreover, enrolment in primary education has increased sharply in the last few years but enrolment in secondary and tertiary education remains very low. Finally, strong expansion of primary education has not been matched by similar improvements in the quality of education: teachers are few, as seen from the high pupil-teacher ratio, and also very low paid which forces them to engage in other income earning activities.[17]

Table 5. Education in Cambodia and Other South-east Asian Countries (2002).

	Adult literacy rate	Primary enrol-ment (net, %)	Second-ary en-rolment (net, %)	Tertiary enrol-ment (gross,%)	Share of total public exp.	Share of GDP	Pupil-teacher ratio (primary)
Cambodia	69	86	21	3	2	15.3	28
Indonesia	88	92	na	15	1.3	9.8	13
Laos	69	83	31	6	3.2	10.6	16
Malaysia	89	95	69	27	7.9	20	23
Myanmar	90	82	35	12	na	na	Na
Philippines	93	93	56	31	3.2	14	30
Thailand	93	86	na	37	na	na	Na
Vietnam	90	94	65	10	na	na	21

Source: www.unesco.org Note: na – not available.

The poor level of education is likely to have a negative impact on a balanced growth path, in particularly on the expansion of industrial production, which typically requires some basic literacy and numeracy and also people with vocational training. The expansion of education in Cambodia during recent years is important and will hopefully help mitigate the problem with a poorly educated labour force and relatively high wages (see discussion below). It should be noted that many neighbouring countries in South-east Asia managed to industrialise despite poor levels of education. In fact, unlike the North-east Asian countries, South-east Asia has traditionally neglected education (Booth 1999a, 1999b). It is likely, however, that the increased global focus on development through export orientation, attraction of foreign FDI, and manufacturing expansion, put more stress on country's ability to provide a skilled and educated work force.

Bureaucratic obstacles seem to be another major constraint on industrial expansion. For instance, to register a firm in Cambodia takes

15 For instance, only about 15 per cent of the population with higher education survived the Khmer Rouge regime (Gottesman, 2002).

16 Results from a UNESCO survey cited in Hach (2003, p.14)

17 Salaries for teachers ranges between US dollars 20–30 per month in 2004.

about 94 days and costs about US$ 1,500.[18] This is longer and more costly than in any of the neighbouring countries, which often compete in the same industries. Compared to Thailand, the cost is 76 times higher and it takes 52 days longer to register a firm. As a result, there are a large number of unregistered firms in Cambodia; about 27,000 in 2003 compared to only 9,000 registered ones. The main problem with unregistered firms is that they are likely to have poor access to credits and marketing support, and that they tend to avoid growing in size. By remaining small, they avoid the attention of public officials and thereby the costs associated with such attention. The costs include both the formal fees mentioned above as well as informal fees or bribes. More specifically, registered firms pay about three times more informal fees than unregistered firms do. Such informal fees are also considerably higher than in most other countries. For instance, informal fees or bribes are estimated to about 5 ½ per cent of sales in manufacturing, more than double the rate in Bangladesh, Pakistan and China.[19] Finally, slow custom routines are a major problem for exporters; it takes on average 18 days to obtain export customs clearance in Cambodia, compared with 11 days in India and 7 in China.

The formal and informal fees increase the cost of production in Cambodia compared to in many other countries. Relatively high wages is another reason to high relative cost of production in Cambodia. Minimum wages are adopted in most of the formal sector and are very high compared to productivity levels as well as to wages in other sectors of the economy. For instance, the minimum wage of $45 a month and an average of $61 a month in the garment sector are substantially higher than in some competing countries such as Vietnam, India, and Sri Lanka (IMF, 2004c, p. 11). In addition, foreign owned firms are required to pay a 100 per cent wage premium for night shifts, and are restricted from operating on weekends and the 22 national holidays. Hence, the minimum wage policy reduces employment opportunities in the formal sector. The policy is highly unfortunate since job creation is, as previously discussed, one of the main challenges for Cambodia. The minimum wage is also making it difficult to compete with foreign producers when relatively high wages are not matched by similar high levels of productivity.

[18] World Bank Bulletin cited in Phnom Penh Post, June 4–17, 2004.

[19] Figures from World Bank Investment Climate Survey cited in IMF (2004c, p. 11).

Concluding Remarks

Few countries have had to make a new start from such appalling conditions as has post-Khmer Rouge Cambodia. Against this background, the progress that has been observed over the past few decades, and in particular since the early 1990s, must be said to represent an achievement of quite some magnitude. This is as true of political changes as of social change and the transformation of the economy. Yet, it would be to err on the side of optimism to argue that Cambodia is securely on its way to a take off.

The perhaps most worrying aspect of Cambodia's development is that relatively robust growth rates of 5–6 percent annually have not resulted in improvements in the welfare of most Cambodians. Economic development is highly concentrated to a few metropolitan areas and most of the country experience stagnant incomes, persistent poverty, and little access to health facilities and anything more than very basic education. We have in this paper suggested a balanced development approach, with emphasis on both agricultural development and industrial expansion, to spur welfare and reduce poverty. Unfortunately, we have also noted a host of policy failures that seriously hampers such development. To address these policy failures requires a dedicated and efficient government; features that can hardly bee said to have characterised Cambodian politics in the past.

Moreover, it is uncertain if one can expect the new Cambodian government to improve upon past records. Even though the stalemate that developed in the wake of the elections in July 2003 was at long last resolved, it was resolved in a fashion that is as close to a recipe for ruin as one could wish for. With an army of new ministers and the swollen ranks of top tier civil servants now filled with political appointees, it does not take a vivid imagination to visualise a still less efficient system of decision making and implementation than the one that has prevailed up to now. Although decision-making is likely to be increasingly centralised to the very top, transparency and a common sense of purpose are likely to suffer. Indeed, if corruption is a problem today, it is not difficult to conceive of further deterioration resulting from the no doubt tricky negotiations that eventually led to a new government.

As the challenges facing the economy alone would ideally require the undivided attention of national politicians, the outlook is not very bright. The removal of the Multi Fibre Agreement along with increasing competition to be expected from the combined effect of WTO membership and the CAFTA process – that is, the free trade agreement between ASEAN and China, signed in Vientiane in late November 2004 – are likely to erode the hard won gains of the past decade or so unless concerted action to mitigate the negative effects and strategies to capitalise on the opportunities offered by these changes are quickly put in place. The fact that Cambodia is still facing a food security problem and continuing high levels of population growth does little to alleviate these concerns. In addition, while government spending is constrained by substantial budget deficits and difficulties in increasing revenues, social and regional inequality is on the rise. Health and education needs are by no means met even at low levels of ambition and the backlog in supplying basic infrastructure is overwhelming. Again, while GDP growth over the past few years has been quite substantial, there is little reason to adopt a sanguine attitude.

All in all, then, provided that the conventional wisdom is correct in suggesting that increased incomes and productivity levels in agriculture are critical and that the major contributing factors to such a desirable outcome are not immediately apparent, Cambodia does not seem ready for a take off. A substantial and continuous shift from subsistence production to market based farming and an expansion of job opportunities in the secondary sector are simply not on the horizon. There is little to suggest that the policies that conceivably could contribute to poverty alleviation by virtue of making possible continued economic growth are in place or imminent. Adverse initial conditions and a less than a fully conducive external environment are no doubt important hurdles, but domestic developments are the key to any potential improvement.

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SWEDISH INTERNATIONAL
DEVELOPMENT COOPERATION AGENCY

SE-105 25 Stockholm Sweden
Phone: +46 (0)8 698 50 00
Fax: +46 (0)8 698 56 15
sida@sida.se, www.sida.se