Chapter 5 | Regional Economic Integration

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“JapanCorp” is a Japanese multinational corporation that produces machinery components and electronics devices. The company owns multiple production plants in several countries in Asia, including Cambodia. The decision to open their factory in Cambodia was driven by a combination of the firm’s risk diversification program, enhanced market access in the region, and the availability of skilled Cambodian labor. In addition, the operation was at minimal cost due to the RGCs pro-trade and pro-investment policies.

The completion of all legal procedures necessary to get the factory up and running was smooth and swift. Employing over 1,200 Cambodian workers, JapanCorp built its production facilities in a special economic zone on the outskirts of Phnom Penh. The zone boasts a liberal business environment, an effective administrative system, and efficient infrastructure.

A large number of the workers are sourced from a number of national TVET institutions. These institutions are in partnership with multiple industry players, including JapanCorp, to build human resource capacity corresponding to the needs of industry. Frequently, these firms send their technical staff to provide training to students at various educational institutions. Workers at the plant also have access to the company’s different in-house training programs. High-level technical and senior management staff are frequently sent to the firm’s Thailand plant for senior technical training.

JapanCorp's Phnom Penh plant focuses on assembling small- and medium-sized motors, household electrical appliances, and digital equipment. It sources most parts from plants in Thailand and Vietnam, in addition to domestic factories owned by Cambodian, Japanese, and Chinese manufacturers. Most of the assembled finished products are exported to ASEAN markets, China, Japan, and India. These are among the markets with whom Cambodia has bilateral free trade agreements.

The plant's financial transactions with business partners are done digitally through a swift and secure online banking platform. The firm commissions a partnered customs broker to deal with import and export procedures. Thanks to the firm's 'Authorized Economic Operator' status and an improved customs process with full-fledged automation, the import and export process is fast and efficient. Inbound and outbound logistics are supported by the inter-connected infrastructure developed under China's Belt and Road Initiative (BRI) and ADB's Greater Mekong Subregion (GMS) Economic Corridor Program in addition to Japan-backed port capacity expansions.

I. Regional Economic Integration: The Ideal Scenario

The description above represents a snapshot of the culminating vision for the next twenty years. It is motivated by Cambodia's anticipated impressive growth within both regional and global value chains (GVC). Hummels et al. (2001) and Koopman et al. (2010) define GVC participation for a reference country where the country embeds its value-added in exports both looking backward and forward. The backward participation happens when the country's domestic firms use foreign inputs for exporting activities. The forward participation happens when the country's exports are used as inputs by firms in partner countries for their own exports. Kowalski, P. et al. (2015) provides a good contextual analysis on GVC participation and policy context in developing countries. Connecting to the global value chains is a powerful driver for economic growth in terms of job creation, greater opportunities for domestic firms, enhancement of productivity, sophistication, and diversification of exports. In this spirit, the vision of having a strong participation in the GVC is not new for Cambodia but the result of decades-old strategic decisions about the future.

By 2040 Cambodia will have built upon the initial basis it established to embed itself further up the value chain, through the pursuit of policies and reforms for promoting foreign investment and cross-border trade.[4] The effort has led to a significant economic transition towards upper-middle income status and higher value-added manufacturing and production.

To aid its ambitions, the kingdom has established a number of special economic zones (SEZs) around outer-city transport hubs. These have been established in Phnom Penh, Sihanoukville Seaport, Poipet, Bavet, Battambang, and Svay Rieng. These zones are designated as duty-free industrial parks to encourage production and foreign investment. In addition to their productive merit, each zone has developed a technical and vocational training college (TVET), funded by industry, in order to train domestic workers in the relevant skills and competencies to meet market demand.

The quality of Cambodia's human capital has substantially improved through upskilling in a targeted program of digital education. Recognizing the necessity of digital literacy for a productive and adaptive workforce, Cambodia has successfully overseen a digital revolution around banking, governance procedures, and communication. The extensive utilization of e-platforms, and the streamlined procedures surrounding them, has seen Cambodia become a sought-after destination for foreign investment and business development. Having intelligently earmarked a need for foreign firms to invest in domestic

[4] As has been the case since the country's return to a market-oriented economy in 1989. The latest and most important 'economic growth strategy' – the Industrial Development Policy 2015–2025 (IDP) – has continued the goal of modernizing Cambodia's industrial structure from a labor-intensive industry to a skill-driven industry, through connecting to regional and global value chains; integrating into regional production networks and developing interconnected production clusters along with efforts to strengthen competitiveness and enhance productivity of domestic industries; and moving toward developing a technology-driven and knowledge-based modern industry.

workers through schemes such as the TVET colleges, there is a growing regional challenge from Cambodian firms in high end electronics manufacturing.

In addition, in 2040 Cambodia continues to enjoy strategic and economic benefits from its membership in an increasingly integrated and cohesive ASEAN community, which in itself is the hub of economic and political-security architecture in the wider region around which GVC activities are organized. With global production shifting toward the Asia Pacific, most countries in the region, Cambodia included, are becoming 'factory' economies, which source much of their value-added from other regional countries to produce exports. Large corporations will have a stronger interest in opening factories in Cambodia as part of their 'China+1', 'Thailand+1' or 'Vietnam+1' approach to take advantage of the increasingly connected region and to diversify their operations.[5] As such, Cambodia's manufacturing sector will have experienced a greater transition toward higher value-added products while textile and related garment industry will have incorporated higher value-added activities.

Cambodia's ranking in the World Bank's Doing Business Index as well as its governance indicators will have seen significant improvement, with another series of reforms to address the long-standing governance and public capacity issues – thanks to strong commitment by the government. The kingdom's economic success continues to give legitimacy to their regime and administration. These reforms will have addressed significantly the public capacity constraint issues of coordination, accountability, government effectiveness, rule of law enforcement, corruption, and will have strengthened the country's business environment including business licensing and operating permits, customs and trade regulations, tax rates and tax administration, and regulatory policy uncertainty. With these reforms, the majority of businesses will have formalized themselves and engaged more extensively in GVC activities. At

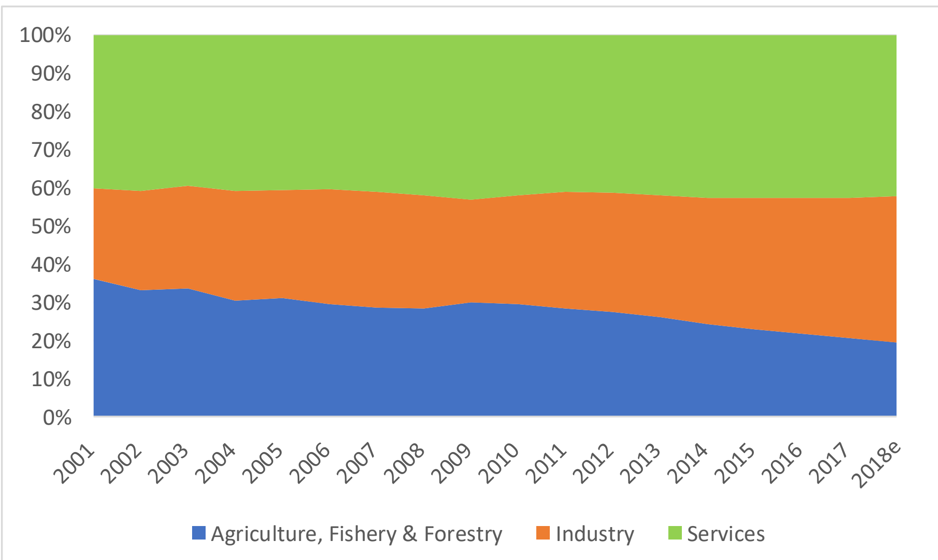
[5] These 'X Plus 1' refers to a strategy whereby corporation branches out from their plants in X by opening production facilities in other regional countries, basically to diversify risk, control cost, and access to new markets.

the same time, these reforms will have unlocked the full potential of Cambodia's private sector in all leading industries.

II. Scenario Space and Key Factors for Regional Economic Integration

Since 2001, the real GDP growth rate has averaged 7.7 per cent per year and has been at least 6 per cent every year except in 2009, during the global economic slowdown. In 2018, the economy recorded a strong growth rate of 7.5 per cent and GDP size of around US$24.4 billion. Figure 1 illustrates the sectoral share of the economy during the same period. Industry accounts for 36 per cent of GDP, up from 22 per cent in 2001. The share for services holds stable at 39 per cent from 38 per cent, while agriculture declines almost halfway to 18 per cent from 34 per cent during the same period.

Figure 1: Sectoral share of the economy, 2001-2018



Source: Ministry of Economy and Finance (MEF).

Currently, Cambodia's GVC engagement is limited to only a few industries. On the industry front, the country has thus far embraced the 'factory Asia' growth model, relying on its inexpensive low-skilled labor and foreign value added to boost its garments and footwear for exports. The fact that garment exports account for 77 per cent of total exports, with 80 per cent being sold to just eight partner countries, mostly to the EU and US,[6] is worrisome. Despite its membership in the Association of Southeast Asian Nations (ASEAN), Cambodia has not yet fully reaped the benefits of this regional integration, considering the country's insufficient volume of intra-ASEAN trade compared to other countries in the region. Only around one fifth of Cambodia's exports are sold to ASEAN member states.[7] The use of tariff preferences among Cambodian businesses is low and relatively few Cambodian companies apply for preferential certificates of origin under ASEAN-related Free Trade Agreements. On the agricultural front, primary processing still makes up the majority of agro-industry.

Against this backdrop, the 2040 vision is to see Cambodia securing a strong position in the GVC and the country becoming one of the most competitive countries in the region. This is predicated on the development of the following key factors: (i) geography, (ii) overseas market access, (iii) public sector capacity, (iv) infrastructure and logistics, (v) improved industrial human resources, and (vi) an adaptive and innovative economy.

Geography. The growth prospects, demographics and social dynamics of the Mekong Subregion attract the interest of many global investors. This subregion is an integral part of the ASEAN community and will have witnessed a rapid pace of intra- and extra-regional connectivity and integration, shaping the ways businesses operate in member countries in terms of value chain expansion. Moreover, the Mekong Subregion is well positioned as an engine of regional development cooperation and multilateralism, with the emergence of over a dozen cooperative mechanisms pertinent to the region and various aspects of its development. These include the Greater Mekong Subregion (GMS), the Ayeyawady-Chao Phraya-Mekong Economic Cooperation (ACMECS), the Lancang-Mekong Cooperation (LMC), Mekong-Japan Cooperation, Mekong-Ganga Cooperation (MGC), Mekong-ROK Cooperation, the Lower Mekong Initiative, and China-led Belt and Road Initiative (BRI) among others. They

[6] Atlas of Economic Complexity, Center for International Development.
[7] Ibid.

promote infrastructure development, industrial zone development, human resource capacity development, trade links, and people-to-people connectivity. Cambodia will have benefited greatly from these mechanisms, from connectivity to labor market development to cross-border trade.

Overseas Market Access. Following the return to a market-oriented economy in late 1980s, Cambodia began its campaign to liberalize the country's economy to increase trade and attract foreign investment. For example, Cambodia joined ASEAN in 1999 and the World Trade Organization (WTO) in 2004. Broadly, they are the two main multilateral institutions helping Cambodia expand its merchandise export market. Membership in these institutions continues to help Cambodia attract more foreign investors and have access to greater and more secure markets abroad.

By 2040, we anticipate that Cambodia will have fulfilled the integration process with ASEAN and investors in the kingdom can produce and export their products to the ASEAN regional and other dialogue partners' markets. ASEAN alone will see its population reach 770 million and collectively this grouping will be among the top four economies in the world in purchasing power parity terms, alongside China, India, and the US. The anticipated social dynamics are highly positive with rising income and greater access to the flourishing digital economy. A huge middle class along the China–ASEAN–India corridor will create high consumer demand with significant spending.[8] The successful conclusion of the Regional Comprehensive Economic Partnership (RCEP) facilitates trade and investment and further deepens the engagement of Cambodia with other ASEAN member states and ASEAN's six free trade agreement partners including Australia, China, India, Japan, South Korea, and New Zealand. While the RCEP negotiating text was not available at time of this study, the trade bloc agreement is meant to be a single tariff offer by RCEP partners to all the ASEAN countries and from ASEAN members to all RCEP partners. This means Cambodia is treated the same as Thailand, Malaysia, and others, in terms of market access. The opportunity for

[8] See Economic Research Institute for ASEAN and East Asia. (2019, June 11). ASEAN Vision 2040: Towards a Bolder and Stronger ASEAN Community.

Cambodia is substantial given a strong export capacity the country will realize per the scenario set out herien.

Cambodia will also have opened new markets by concluding its accession into the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CP-TPP) and bilateral free trade agreements (FTA) with a number of potential partners, i.e., Japan and China. With that, Cambodia will have reduced overdependence on the ASEAN Framework as the foundation for FTA and capitalized on broader oversea market access opportunities in terms of tariff concessions and rules of origin under the respective arrangements. This helps Cambodia to stay on par with its peer ASEAN neighbors who have already entered into economic and trade partnership agreements with these markets to a different extent. A bilateral FTA with Japan, for example, provides better market access than current trade relations, which are governed by the GSP for LDCs and the ASEAN-Japan Comprehensive Economic Partnership (AJCEP) Agreement. A bilateral FTA with China will elevate already-strong economic ties with China, with whom Cambodia established the Investment Promotion and Protection Agreement in 1996 and Comprehensive Strategic Partnership Agreement in 2010.

Infrastructure and Logistics. The successful transition up the global value chain requires a country to have an efficient logistics system and suitable infrastructure. Currently Cambodia has plans in place to promote some development along these lines. For example, the Master Plan for ASEAN Connectivity (MPAC) was adopted in 2010 and enhanced in 2016 to promote connectivity in all dimensions, including infrastructure, digital, logistics, regulatory, and people-to-people connectivity. The cooperation among Mekong countries commenced with the launch of GMS in 1992 by the ADB, bringing together Cambodia, Laos, Myanmar, Thailand, and Vietnam (frequently referred to as CLMTV) and the southwestern region of China. The transport sector has been the most prominent of all investment projects under the GMS framework. The country's 'missing link' of road and rail networks that form important domestic and cross-border transport corridors will have been completed under these and other mechanisms initiated by major powers including China and Japan, among others.

Of particular importance is Cambodia-China cooperation. This so far appears to be most promising in addressing physical transportation and logistics obstacles, with China-led financing institutions including the Asian Infrastructure Investment Bank (AIIB), Silk Road Fund, and the New Development Bank becoming alternative sources of financing for infrastructure investment projects in Cambodia. The China-led Belt and Road Initiative (BRI) and its associated projects such as the Sihanoukville Special Economic Zone (SSEZ) greatly contributes to skills growth in the labor market in general as well as to the development of the multi-purposed Special Economic Zone in Sihanoukville. The PHN-SHV expressway and two new airport projects in Phnom Penh and Siem Reap will be in full operation in the next decade and significantly enhance connectivity and logistics within Cambodia and beyond, improving logistic efficiency, reducing trade costs, and deepening regional integration.

Improved Industrial Human Resources. The quality of Cambodia's human capital will also have substantially improved through upskilling and mobilizing the workforce in the context of a broad-based industrial and digital economy. This is enhanced by the mainstreaming of human capital development in many of the aid programs which coincides with the galvanizing of reform momentum in the educational system including: raising teacher salaries; strengthening the integrity of the examination process integrity; integrating information and communication technology (ICT) and science, technology, engineering, and mathematics (STEM) skills into the educational system; improving TVET quality to meet the needs of industries; and linking the formal education system and TVET to industrial policy.

An Adaptive and Innovative Economy. Cambodia is poised to embrace a full-fledged digital economy. An enabling legal environment is needed, including the introduction of an e-commerce law, competition law, consumer protection law, and regulations regarding data security and privacy. An improving ICT infrastructure is helping to develop Cambodian business: including the Asia Submarine-Cable Express (ASE), and the Asia-Africa-Europe-1 (AAE-1), and fifth generation mobile network.

The use of technology will have spread to and benefited all sectors. Agriculture will have seen a substantial improvement in productivity, diversification, commercialization, and exports, with an increased level of mechanization. Although rice remains the dominant crop, the sector will witness growing production and exports of other crops such as rubber, vegetables, sugarcane, cassava, maize, cashew nut, pepper, palm oil, mango, and banana. Secondary processors will have grown bigger in both number and capacity due to the increasing use of modern technologies and spillovers from increased local and foreign investment possessing the financial and technical capabilities to process crops geared toward export. The manufacturing sector will have experienced a greater transition toward higher value-added products. There will be a noticeable development in newer manufacturing and export sectors, i.e., electronic equipment, machinery, and automotive spare parts. The service sector will have seen the highest level of ICT utilization, led by the embrace of digital transactions and fintech.

III. Policy Initiatives to Achieve the Ideal Scenario

What follows is an attempt to lay out a road map to transform anticipation into action such that Cambodia will realize the ideal scenario outlined above in this chapter. The menu of priorities and issues to address is long and daunting when it comes to building stronger value chain linkages between domestic and foreign firms that help embed Cambodia's 'factory economy' deeper in regional and global value chains.

Strengthening Market Access Abroad. Advancing bilateral FTAs negotiation with its key economic partners for new market opening is key. As for multilateral agreements, Cambodia must work with other countries in the region to expedite negotiations on the RCEP and explore the opportunity to join the CP-TPP and Asia-Pacific Economic Cooperation (APEC). Expanding market access has become even more crucial now than ever before, given the potential removal of duty- and quota-preferential access treatments, such as Brussels' Everything But Arms (EBA) and Washington's Generalized System of Preferences (GSP).

For domestic firms to benefit from any new market opening to its fullest, promoting information access as to the new trade agreements and how these businesses could benefit from them is equally important. Trade financing must be encouraged to help SMEs export their products. Cambodia may mobilize technical cooperation with other more advanced partner countries including Japan, South Korea, China, and Australia, to help SMEs develop better and quality products that are more competitive.

Building Stronger Reform Momentum in Trade and Investment. Despite ASEAN membership, the use of tariff preferences among Cambodian businesses is low and only relatively few Cambodian companies apply for preferential certificates of origin under ASEAN Free Trade Agreements. A majority of businesses cite a lack of information as the main reason for not using preferential access from free trade agreements. Other bottlenecks include excessive and time-consuming documentation processes and the increasing complexity in border measures, among others. While trade facilitation has thus far seen a noticeable improvement (i.e., online Certificate of Origin, implementation of ASYCUDA at all ports and checkpoints, launching of Cambodia's National Trade Repository (NTR) and CNSW, the country’s compliance and commitments of the ASEAN Economic Community (AEC) have only been partially completed. Within this context, Cambodia needs to strengthen the implementation of its commitments to trade liberalization under both ASEAN and WTO agreements and push forward trade- and investment-related reform momentum to fully reap the benefits of ASEAN integration.

To enhance the implementation of the kingdom’s commitments to trade liberalization, Cambodia needs to make more progress in digitalizing trade facilitation. Legal and regulatory frameworks for electronic transactions and signatures as well as for accessing and sharing information and data need to be put in place. All trade-related agencies have to adopt and deploy the ICT system to simplify and automate their trade-related procedures. At the time of writing, there is an overall absence of coordinating institutional mechanisms in this regard. Going forward, work towards the establishment of the Trade Facilitation Committee must progress without delay, to create a coordinating platform for resource mobilization for strengthening human, technical, and organizational capacity to give a boost to digital trade facilitation implementation. Some development programs are already in place where Cambodia may consider leveraging these institutions' support in this regards, i.e., UNCTAD Empowerment Program on National Trade Facilitation Bodies, EU-ASEAN Regional Integration Support (ARISE Plus). In its operation, this mechanism needs to ensure full empowerment of the lead agency and encourage greater participation of both relevant public agencies and trader communities to secure broader stakeholder buy-in.

Cambodia must speed up its efforts in the establishment of a fully-operational and well performing NSW to integrate with the ASEAN Single Window (ASW) and adopt ICT eco-system for business-to-government (B2G) and business-to-business (B2B) that connects trade, logistics, business, and government together to better support needs in the fast-evolving business landscape. While the NTR has enhanced the transparency of trade-related information and trade regulations, the information contained on the Trade Repository will necessarily change to reflect updates as the NTR evolves over time. An improved management of non-tariff measures (NTMs) is also called for to ensure transparency, streamlining of certification procedures, and the harmonization of NTMs where feasible. With the majority of NTMs being technical barriers and sanitary and phytosanitary (SPS), one major way of reducing the trade cost and burden on business and consumers is to invest in robust quality infrastructure that aligns with international standards, i.e., testing laboratories, conformity assessment, and certification and accreditation bodies.

The contribution of Cambodia's open trade and investment regime to connecting domestic and foreign firms along the value chains has not always been as strong as it could be due to a broad range of issues, i.e. lack of industrial cluster, high rates of informality, credit constraints, inadequate supply and cost of energy, among others. The SEZs have proven successful at attracting investment and diversifying the manufacturing base to some extent, i.e., manufacturing and export base in new sectors such as electronics, bicycles, automotive parts, and agri-business products. The spillovers, however, from these zones to the rest of the economy have been limited, particularly due to limited private sector capacity that cannot produce significant backward linkages. Improvements would be seen if non-SEZ businesses co-locate with SEZ investors. That is, if these firms could operate on SEZ land, even if they do not receive the same incentives that SEZ investors receive. This would create more clustering and encourage spillovers into the broader economy.

High rates of informality[9] make any effort in connecting the domestic businesses to regional and global firms challenging, while at the same time masks the severity of business regulation constraints, i.e., business licensing and operating permits, customs and trade regulations, tax rates and tax administration, regulatory policy uncertainty, corruption, and anti-competitive and informal practices. To entice firms in the informal sector to move into the formal sector, serious reforms are required to address these constraints.

Interventions should focus on improving both sides of the cost-benefit equation of going formal. On the cost side, this includes not only the time and costs associated with registering a business, but also the ongoing compliance and administrative burdens associated with regulations, taxation, and dealing with government authorities. The benefits side includes improved access to financial and other business development services. At the same time, trust between the government and informal businesses must be built. Businesses are more often than not concerned about the government wanting more information about them (to tax and regulate them) rather than about possible assistance. The government needs to build this trust, especially with the small business community, perhaps through engaging business associations such as the Federation of Association of Small and Medium Enterprises of Cambodia (FASMEC) and strengthening the Government-Private Sector Forum (GPSF).

According to the National Bank of Cambodia, credit provided to the private sector has risen but much of the credit growth has been directed to construction and real estate-related activities (35 per cent in 2018); credit growth contribution of agriculture and manufacturing are much lower, at 0.6 and 0.4 per cent respectively (National Bank of Cambodia, 2019). The credit constraints hinder

[9] 98.8 per cent of businesses of less than ten employees being unregistered, according to Cambodia Inter-Censal Economic Survey 2014.

diversification of the Cambodian economy by constraining growth in sectors where access to finance is particularly challenging. It has prevented businesses' ability to expand, to invest in new equipment and technology, to gain access to foreign markets, and to manage their liquidity efficiently. Better credit management must be in place to ensure the health of the overall financial sector, i.e., regulate lending and additional taxes on sales and purchases of property, especially for speculative purposes. Cambodia also needs to consider enacting legislation that would allow more financial flows for investment (in manufacturing) purposes, with special collateralization and other schemes. Increasing the supply of educated entrepreneurs – individuals who can run productive businesses – is equally important. This will help the Cambodian private sector to be more efficient and dynamic; such entrepreneurs are more likely to create modern, registered businesses rather than inefficient and informal ones. Development partners could provide technical assistance to complement investment in business incubators.

Improvements in Governance and Public Capacity. The Anti-Corruption Law adopted in 2011 and the creation of the Government's Anti-Corruption Unit have yet to produce a significant reduction in corruption. In the near term, hopefully, the Prime Minister's "sharp" new package of reform measures with his five approaches of "looking into the mirror, taking a shower, scrubbing away the dirt, treating wounds, and conducting surgery" will galvanize reform momentum to specifically address these long-standing governance issues, especially corruption. However, winning people's hearts and regaining public trust in state institutions will not materialize in a short span of time.

Over the long term, the country needs to demonstrate stronger and more consistent political commitment and leadership to carry out the existing reform agenda and to initiate new ones. Leaders must be more adaptive to changes when it comes to reforms and improving institutional capacity, ridding themselves of the belief that 'if there is nothing wrong, there is no need to fix.' Leaders must be more down-to-earth if they are to be more effective in changing social mindsets and values in battling with corruption, which is at present rooted in all aspects of life in the country. Cambodia must encourage and empower more fresh blood in steering the kingdom ahead. Continued suppression of the bright and innovative younger generation in the public sector only results in these individuals leaving or becoming demoralized. To ensure consistent institutional capacity improvement, an independent assessment and monitoring mechanism must be set up to evaluate the performance of each government ministry and state agency.

Governance and public capacity improvement is also vital for proper management of foreign investment to ensure that such investment is consistent with national development objectives. A case in point that calls for proper investment project screening is the 'China issue' in Sihanoukville. The influx of Chinese investments, and thus development, has picked up at a lightning speed in the coastal town. However, basic public services are often failing to keep up with the increasing economic activity. Problems over trash collection and the already-limited water and electricity supplies are worsening. While some Cambodians have been made better off by these investments, minimal trickle-down benefits and adverse effects have left many locals frustrated. Locals view projects as staffing too many Chinese, offering limited job opportunities to Cambodians. Chinese businesses also crowd out local ones, with Chinese money inflating prices of literally everything. The deadly collapse of a Chinese-owned building under construction in the coastal town in 2019 that killed 28 and injured another 26 people was another example of weak rule of law and corruption in the management of foreign investment projects. The building was reportedly being built as a hotel and believed to have been 80 per cent complete without receiving requisite legal approvals. This highlights the needs to strengthen the enforcement of rules and laws.

Upgrading Infrastructure and Logistics. Cambodia is not self-sufficient in electricity. Presently, the country largely uses conventional electricity production to reduce costs and to increase electricity supply. The high share of hydropower means that energy supply is subjected to seasonal changes in the water in the reservoir. The high electricity demand during the dry season only adds pressure to a limited energy supply stemming from frequent droughts, longer dry seasons, and the intensifying impacts of climate change. Unstable electricity supply frequently forces factories and businesses to use their own generators, which is typically more expensive than using energy from the power grid.

Cambodia must diversify sources and broaden its power generation base in a cost-efficient manner while reducing greenhouse gas emissions. Private investment in energy infrastructure should be strongly encouraged.

Geographically well-located in a dynamic region of the Mekong and ASEAN with a vast sub-regional and regional transport network already in place, Cambodia has also laid out the future path of transport infrastructure and logistics development as well as necessary conditions for their sustainability in its national Logistics Master Plan. It sets out an ambitious multi-year strategy for the country's entire transport and logistics sector to improve roads, railways, ports and inland waterways, urban transport, trade logistics, and to strengthen the capacity of all institutions engaged with transport infrastructure and operations. It is only logical to implement existing domestic and cross-border transportation infrastructure and connectivity development strategies in order to achieve improved logistics performance to support the industrial development.

The connectivity development focus of many cooperation mechanisms already in play will contribute to this implementation. Future engagement of private investment through public-private partnership (PPP) models must be encouraged. Some past and ongoing projects have already demonstrated the increasing importance and successes of PPPs in delivering necessary physical infrastructure, i.e., three international airports in Phnom Penh, Siem Reap, and Sihanoukville; the kingdom's railway network; and the Phnom Penh - Sihanoukville Expressway. However, the government should at the same time ensure improvements in data reporting, and transparency - especially around foreign debt, i.e., open government procurement and adherence to high social and environmental standards.

Industrial Human Resource Development. The pressing issues regarding human resource capacity must also be addressed. With economic growth increasing labor costs, the official minimum wage level has risen commensurately over the years,[10] eroding the country's competitiveness vis-à-vis other traditionally low wages countries such as Bangladesh, Myanmar, and Vietnam. This calls for further improvement in labor productivity so to catch up with wage inflation.

The underlying causes of relatively low human capital, and thus lower labor productivity, are complex and interrelated. For example, the cost of schooling is a barrier to education for relatively poor children. Although primary education is free, parents must pay for uniforms, books, and school supplies, as well as various informal fees. Due to their low compensation, teachers often collect informal fees for extra tuition creating a barrier to education. Low completion rates for secondary education reduces the supply of potential students for TVET and university. University degrees, particularly in the social sciences, are much preferred by students and their families to a TVET education – however, they do not match the demands of employers. Quality of education has also been a major issue. Furthermore, skills gaps and mismatches are linked to both access to and quality of education and skills training as well as to the priority (i.e., financing) government gives to different levels of the education system. Insufficient information and coordination with the labor market further compound this problem.

Unfortunately, there are very few quick solutions. Long-term solutions will require reforms to the country's education and training systems, as well as the provision of education and job market information to reduce skill mismatches. The government must make further investment in specialized education (i.e., ICT and STEM) and advanced vocational training with joint involvement from all key stakeholders including the public sector, industrial enterprises, and workers. The reforms must seek collaboration with industry experts and engage teachers

[10] Following the latest round of negotiation between manufacturers, unions, and the government, a new minimum wage of US$182 for the garment sector will kick in January 2019, up from US$170 in 2018. The amount is more than triple from US$61 merely 7 years ago in 2012.

who have hands-on industry experience for TVET curricula development, making it more relevant.

PPPs must also be encouraged, i.e., such as public funds used to contract out management of public schools – with subsidies tied to student performance. Other innovative financing mechanisms such as education bonds are also worth considering, i.e., modelled on development impact bonds. A relatively simple action to improve education would be providing information for parents and students to help them make informed decisions and reduce the information asymmetry that currently exists. Students and their families can find it difficult to differentiate between type, quality, and financing costs of educational providers. Information on returns to education, training, or educational quality can be a low-cost method to overcome mismatches and lead to a better allocation of students and ultimately improved skills. Targeted information must be credible, clear, and concise.

Toward an Adaptive and Innovative Economy. Embracing a fully functional digital economy requires a fully functioning digital society where individuals are equipped with certain capabilities and skills to become digital citizens and workforce. Through its national education system, Cambodia must promote digital literacy; further facilitate the growth of new tech-savvy entrepreneurs and tech companies; and build trust and security in ICT utilization. While the development of an enabling legal environment has seen relatively good progress (the National Assembly only recently approved the country's most anticipated e-commerce law and the competition law is expected to follow suit), the government needs to strengthen regulatory capacity and practice to better manage any tensions arising from data security and privacy, disruptions, competition, taxation, among others. Cambodia needs to encourage a more vibrant ecosystem for the digital startup, i.e., through business plan competitions, mentoring support, HUBs, networking events, co-working spaces, accelerators, seed funding, angel investors, and crowdfunding. At the same time, the country needs to mitigate the negative implication of the digital economy transformation on job markets.

External Environment. The Mekong has become more and more of a new growth center and strategic frontier in Asia. Currently, this is a region of prosperity and potential but also a region of uncertainty. There is a huge shift in economic power in Asia. The United States' retreat from multilateralism and a fractured Europe, alongside a more assertive China and a rising India has resulted in tremendous geopolitical uncertainty arising from the process of realignment of power in the region.[11] Within the Mekong context, member countries' cooperation depends largely on major powers, who frequently lead most of the cooperation dialogue processes. Cambodia needs to manage this external environment and make certain that this environment works in favor of the country's growth and development needs.

While Cambodia is currently viewed as one of China's closest allies in Southeast Asia, the country has begun efforts to diversify its strategic partnerships with other existing and emerging major and middle powers to support its economic interests. The fact that Cambodia has become more and more alienated by the Western world continues to incentivize the Cambodian government to deepen its relationship with Beijing. Given the strength of the Chinese economy (estimated to surpass the US by 2040) and its ever increasing cooperation and integration with countries in the Mekong and ASEAN, China will continue to maintain its economic influence in Cambodia, in terms of trade, investment, and lending. This reality is likely to hold true for years to come. This highlights the need to manage well Cambodia's future relationship with a rising China. The prospect of capital outflow suppression by China to resolve its own current account issues could disrupt Cambodia's economic momentum. Diversifying sources of trade and foreign capital inflows is just as important as diversifying strategic partnership.

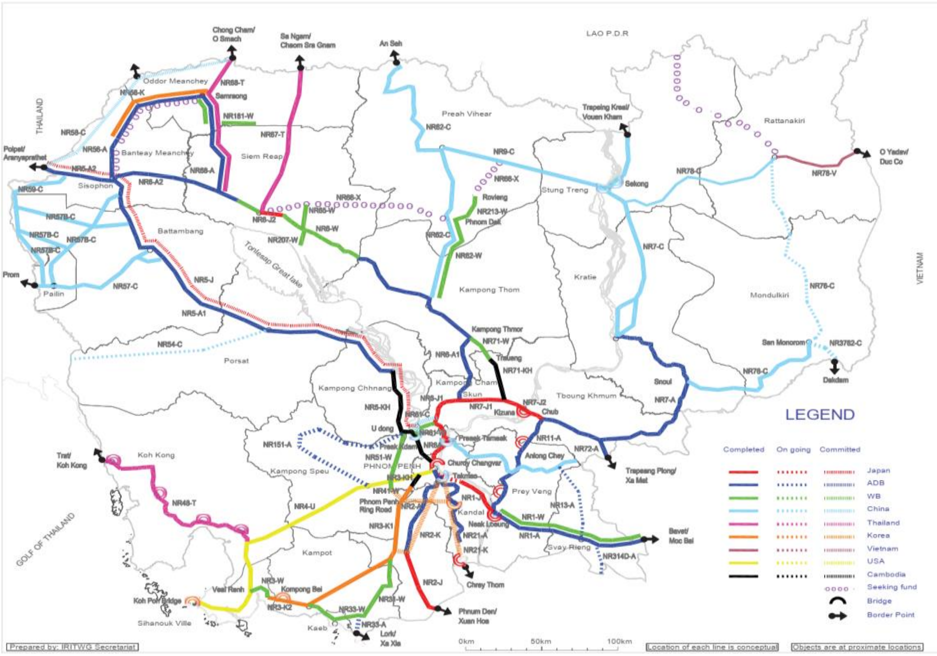
Likewise, Cambodia must work more to diversify development cooperation. The current environment can work effectively for this purpose as various regional major and middle powers, i.e., Japan, Korea, India, among others, have

[11] See Economic Research Institute for ASEAN and East Asia. (2019, June 11). ASEAN Vision 2040: Towards a Bolder and Stronger ASEAN Community.

demonstrated their increasing interest in building stronger partnerships and cooperation with Cambodia and the region in which it resides. To turn this to its advantage, Cambodia must seek a significant role in guiding the development agenda for these cooperative frameworks and ensure linkages, complementarities, and synergies with other local and national programs as well as across different frameworks. While collaboration among different frameworks is challenging due to different levels of political will, commitment, and financing resources, the substantial commonality in transport and connectivity infrastructure focus as well as geographical overlap has great potential for building innovative collaboration mechanism among them inside Cambodia and beyond, i.e., project selection, financing, and delivery; filling in the missing links; and cross-border projects. The synergies will stimulate both hard and soft infrastructure development, effective trade and investment, and industrial human capital development for Cambodia, strengthening and diversifying the industrial base and enhancing competitiveness and productivity in order to move up regional and global value chains. Figure 2 illustrates how transport-related infrastructure projects financed by different development agencies including World Bank and bilateral donors such as Japan, China, South Korea, USA, Thailand, and Vietnam complimentarily contribute to reducing transport and logistics costs while connecting the multimodal transport system through a vibrant national logistics system. Cambodia can also consider extending development cooperation to support the country's readiness for the Industry 4.0.

In addition, Cambodia must ensure that partnership and cooperation with major and middle powers, in any form, do not concern governments alone. These must be built at all levels of society working together to ensure sustainability and to maximize and share benefits while minimizing the negative impact to the greatest extent possible.

Figure 2: Road Network Development Programs as of 2015



Source: Infrastructure and Regional Integration Technical Working Group (IRITWG)

IV. Regional Economic integration Under the Baseline Scenario: Business as Usual in 2040.

The business-as-usual scenario indicates that in 2040 there will be little progress regarding industrialization and the diversification of production and export base if measures are not taken to address all of the pressing issues discussed above. As garment exports account for 77 per cent of total exports, with 80 per cent of which sold to just eight partner countries (primarily to the EU and US), Cambodia's production and export base is narrow and growth becomes vulnerable and gradually constrained over the long term. Concerns regarding diversification and competition looms large after the country faces potential removal of trade preferential treatments from its traditional markets. The fact that the EU has signed free trade agreements this year with Vietnam adds even bigger pressure for Cambodia, one of the four ASEAN countries without any ongoing FTA negotiation with the EU.[12] Closer to home, only around one fifth of the country's exports are sold to ASEAN member states. Accordingly, Cambodia in 2040 under this baseline scenario will rely on a few fragile markets while at the same time depend largely on trade agreements with key economic partners under ASEAN framework. This leaves the country in a relatively uncompetitive position in terms of overseas market access.

Challenges in Fulfilling Commitments to Trade and Investment Liberalization. The overall score as to ease of trading across borders is relatively poor[13] and worrying if there is no acceleration of efforts to fulfill Cambodia's commitments to trade liberalization under ASEAN and WTO agreements. Major bottlenecks will remain, including excessive and time-consuming documentation process, low trade logistics performance, and complexity in border measures, among others. Particularly within the ASEAN context, issues regarding common regional product specialization, quality and standards, lack of understanding and adequate information as to how to import and export, will continue to set back the efforts of Cambodian firms to engage in GVC activities.

Limited Improvement in Public Capacity Constraints. Cambodia already has a low score for most aggregate governance indicators, i.e., voice & accountability, government effectiveness, regulatory quality, rule of law, and corruption control.[14] Transparency International's global Corruption Perceptions Index 2018 ranked Cambodia very low: 161 out of 180 countries. Governance and public capacity issues will remain if certain measures described in earlier section are not taken. The implication of having failed to address all of these governance and pubic capacity constraint issues will put greater pressure on Cambodian private sector development. This yields far-reaching negative

[12] The European Union secured free trade agreements with Singapore and Vietnam. Separate talks with Indonesia and the Philippines are ongoing, while talks with Malaysia and Thailand have been on hold.
[13] Ease of doing business in Cambodia, World Bank Group. Available online at: https://www.doingbusiness.org/en/data/exploreeconomies/cambodia
[14] World Bank's Governance Indicators.

externalities, as it affects the efficiency of public services ranging from investment-related business licensing and operating permits applications to taxation to custom clearance and other services. Informality prevails. The practice of having to give gifts to officials to get things done will prevent quality foreign investments from entering Cambodia.

Low Infrastructure Capacity and Logistics Performance. The country continues to face challenges in mobilizing resources and relies heavily on external financing for infrastructure and connectivity development. Even with the successful establishment of the Law on PPP, if enforcement and implementation does not build up momentum, this will result in a lack of motivation among private sector actors to engage in public infrastructure development projects in a consistent manner. Logistics performance is already significantly lower than many other regional countries. The Logistics Performance Index 2018 (LPI) ranked Cambodia at 98 out of 160 economies; the country scored the worst and positioned itself at 130 for the infrastructure component of the Index.[15] Within the energy sector, Cambodia in 2040 would continue to rely heavily on conventional electricity production, i.e., hydro and coal power plants, to reduce costs and increase the electricity supply to cope with increasing demand. This practice will also result in critical environmental challenges.

If there is no action to address them, all of these issues will continue to result in uncompetitive energy prices and trade costs, which in turn will have negative implications for the investment climate and the costs of doing business in the country. As trade costs weigh heavily on Cambodia's export structure and exporting firms' performance, relatively higher trade costs will hinder the countries competitiveness even further.

Low Labor Productivity. Low labor productivity only weighs on expansion and diversification objectives. Over the short term, with wages rising rapidly and Cambodia facing the potential removal of existing trade preferences, the country's attractiveness for the garment and textile industry investment is likely

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[15] https://lpi.worldbank.org/international/global, accessed on August 27, 2018.

to erode. Over the long term, fierce competition with other countries producing similar products intensifies. This industry faces a substantial risk of being overtaken by other low-wage nations, including Bangladesh and Myanmar, where relatively abundant and inexpensive labor forces cannot yet command the same wage hikes for which workers in Cambodia have fought. Human resource capacity constraints will continue due to the low education and skill levels of the workforce; uneven quality and retention rates in primary and secondary education; and inadequate TVET responsive to labor market demand.

Failing to Embrace a Digital Economy

Similarly, the workforce in this baseline scenario is not capable of embracing the arrival of Industry 4.0. Technological changes will destroy some jobs, particularly among occupational categories in the factories, while generating new high-skill oriented jobs and occupations for which the workforce is not well prepared. Cambodia is already categorized as one of the countries in the world with the lowest stage of digital readiness, being ranked 109 among 139 countries by the World Economic Forum in its Networked Readiness Index.[16] Our business-as-usual scenario indicates Cambodia's digital transformation as not getting better as the country fails to embrace a competitive digital economy, giving rise to information asymmetries, higher transaction costs, ineffective and inefficient delivery of products and services, and lower productivity of capital and labor.

Challenges in Managing the External Environment

Cambodia's overdependence on China will only increase should the kingdom decide to limit its engagement with other partners to the level extant at present. The absence of investment diversification will make the country extremely vulnerable to disruptions stemming from China's capital controls. A slowdown or reversal of FDI inflows from China will significantly affect private sector growth.

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[16] http://reports.weforum.org/global-information-technology-report-2016/economies/#indexId=NRI&economy=KHM, accessed on September 03, 2018.

This overdependence on China will also increasingly constrain Cambodia's policy options as regard both international relations and economic development, giving rise to the risk of damage to the spirit of unity, cohesiveness, and centrality of ASEAN. The debate as to whether China has had the upper hand in ASEAN is ongoing, with different narratives presented as to whether Cambodia and a few other less-developed ASEAN members have facilitated Chinese veto power over ASEAN. In a worst case scenario, this will likely lead to the cracking of the ASEAN shield that has long protected and promoted Cambodia's economy, security, and stability.

However, there is also a strong likelihood that other ASEAN states will not try to distance themselves too much from China so as not to miss out on the economic and development opportunities that China has to offer. As far as Cambodia is concerned, the deeper the country falls into China's sphere of influence, the more it will be alienated by the West, leaving the country more prone to issues regarding democracy, human rights, transparency and information access, social and environmental care, and engagement with civil society.

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