

Cambodia's WTO Accession: Risks and Benefits

Broad Messages

The recent completion of negotiations and the expected endorsement of Cambodia's entry into the World Trade Organization are substantial milestones not only for the Cambodian economy but for all Least Developed Countries that seek to leverage the benefits of trade. These countries understand the lesson of the past two decades: integration with the world economy works for development. Those with the highest trade to GDP ratios, let's call them the "integrators," grew their GDPs on average 3.5% per year in the 1980s and 5.0% per year in the 1990s, while the "Non-integrators" grew just 0.8% in the 1980s and 1.5% in the 1990s.

WTO is an institution that derives its strength from the commitment of its members to managing trade with a common set of values: openness, transparency, predictability, non-discrimination/multilateralism and a rule-based dispute resolution. If you think about these values, they are many of the same that Cambodia is trying to instill throughout its economic and social development. Joining WTO improves market access, and also sends a strong signal to trade and investment partners about Cambodia's future direction.

But WTO is not a panacea. Leveraging the benefits of market access will require substantial reforms, which go far beyond what Cambodia has committed during its negotiations. Cambodian domestic producers face a number of impediments beyond tariffs that tend to undermine the benefits of market access. Take the example of rice, the nation's most abundant crop. What good will open international markets do for a farmer who cannot sell his crop because the local miller has no access to working capital, pays five times the regional average for electricity, has no tertiary roads with which to reach markets, and must deal with overlapping inspections and unofficial fees at the port? To truly impact poverty, reforms need to be carried out throughout the value chain and inside the border. Trade policy is an important first step but by no means the last.

Nor is the global trading system perfect. Many developed countries maintain high tariff peaks or non-tariff barriers – protectionist policies – that close markets for products Cambodia would like to export. WTO offers a mechanism to address such problems, and I'm sure Cambodia will become an important new voice in the forum representing the interests of least-developed countries. Recent breakthroughs on the question of agricultural subsidies are one example.

The post-WTO environment will be one that rewards competitive firms more clearly and penalizes uncompetitive firms. Even with the transition periods arranged by Cambodia's negotiators, WTO accession puts urgency into removing impediments to the private sector. It is very encouraging to note that WTO has catalyzed reform. The Sr. Minister of Commerce recently noted that the Government is using WTO as a catalyst to propel 98 separate tasks to be undertaken by 20 separate Ministries and agencies by 2006.

Responses to specific questions:

1) which industries would be affected and how?

Trade impacts nearly every industry, particularly since Cambodia has a very open economy. But Cambodia also has a very narrow industrial base, dominated by one industry – garments.

The garment sector is of key concern to many, because it employs 240,000 workers and up to a million who depend on their earnings. Under the WTO's Agreement on Textiles and Clothing, international garment trade has been managed through quotas. Under a bilateral deal with key markets, Cambodia enjoyed quotas which attracted the industry to invest and grow. The US linked the volume of these quotas to corporate social responsibility, and the quotas expanded along with improved practices. When the ATC is finally eliminated at the end of 2004, WTO members like Cambodia will not be restricted by quotas. In this short run, Cambodia may see an increase in investment as garment factories in non-WTO members – who will still be subject to quotas- shift to Cambodia. In the long-run, without reform, cost pressure may force consolidation.

It is fair to assume that the post-2005 garment sector will roughly follow the example of current non-quota exports to the US. Cambodia already sells much more in volume terms outside the quota than inside, and non-quota business has expanded very rapidly. However, prices for products restricted by quota are nearly five times higher than non-quota prices. Furthermore, prices for non-quota sales have declined continuously since 2000 and are now barely above \$1 per square meter. As volumes increase and prices decline, the industry is likely to (a) depend heavily on cost competitiveness; (b) become, to a greater extent than before, a volume-driven business; (c) become even more concentrated, with fewer very large factories able to provide comprehensive services at low cost dominating the sector; and (d) consolidate across borders, as economies of scale become more important than quota allocations. While none of these factors are expected to be immediate, it is not clear how long Cambodia will remain a large garment exporter unless it increases competitiveness including reducing cost and retaining CSR advantages.

But the garment sector story is instructive in another sense. The sector demonstrates that market access leads to growth. Through WTO, the painstaking process of negotiating bilateral deals for every product and every major market is replaced by a rule-based system which, through the mechanism of non-discrimination, immediately grants Cambodia with Most-Favored Nation status with all member countries.

So you can see that the economic logic of WTO accession is not to target particular industries, but to support industrial diversification by applying the lesson from the garment industry: market access can be a powerful stimulus to development.

(2) What would Cambodia have to do to comply with WTO rules?

This can't be a short answer, since although WTO does contain a set of basic agreements that supercede the General Agreement on Tariff and Trade (GATT), a member country's compliance obligations are defined through a negotiated process that is unique to each new member.

The general obligations are those that follow the principles I mentioned above. Cambodia must apply the same trade policies to all WTO members (with exceptions for regional agreements) and must treat foreign goods no less favorably than domestically produced ones when applying trade-related regulations (such as food safety standards). Cambodia has also promised not to use quotas or export subsidies; instead it is supposed to use tariffs which are more transparent. It has promised not to increase the level of ordinary customs duties above levels negotiated with other WTO members.

The specific obligations are more interesting. In Cambodia's case, a team led by Chief Negotiator and Minister of Commerce Cham Prasidh and Secretary of State for Commerce, Sok Siphana negotiated with a "working party"¹ fairly intensively since 1999. Over this timeframe, members of the working party have raised a number of issues and questions to ascertain whether Cambodia is taking the necessary steps to become a responsible and capable member of the global trading community. On 22 July the working party signaled that all outstanding issues have been resolved, and Cambodia was invited to join during Cancun Ministerial conference in September 2003. To summarize, the following appeared to have been important to the positive recommendation of the working party:

- Cambodia's work toward macroeconomic stability based on a flexible exchange rate;
- New tax and investment regimes, including amended Law on Investment;
- Commitments to further progress on legal and judicial reform, including establishment of commercial courts and a number of key laws in process, such as the code of civil procedure, commercial code and bankruptcy code;
- Transparency and continued reform with respect to state ownership of enterprises and any state-controlled prices;
- Reform of import licensing regimes;
- Reform of customs duties and charges and the provision of a dispute settlement mechanism;
- Immediate implementation of the Trade-Related Investment Measures (TRIMS) agreement;
- Implementation of the WTO Rules of Origin Agreement by January 1, 2005;
- Implementation of the Trade-related Intellectual Property Rights (TRIPS) by January 1, 2007;
- Implementation of the WTO Customs Valuation Agreement by January 1, 2009;
- A commitment to publish all laws and regulations on a website according to WTO requirements;
- Binding export subsidies for agriculture at zero.

This is a partial list, and yet may understate their meaning. To provide a better explanation of the impact, let me take one example - reform of import licensing regimes.

Cambodia is known to use import licensing to control trade in a number of products, including pharmaceuticals, fertilizer/pesticides, and some construction materials. As we've learned around the world, licensing requirements and import restriction not only raise domestic prices, but they create opportunities for corruption as people turn to smuggling, bribery or counterfeit products to satisfy the artificially high demand created by such regimes. Going back to the rice example, we know from examining the value chain that a licensing requirement means that only five firms are allowed to import fertilizers. On further examination, we found that Cambodian farmers spend three times more on fertilizers than Thai farmers, yet their yields are 10% lower. We analyzed it a little further, in fact purchased some fertilizer in a local market, and found that local traders had diluted it some 70% to increase their profits at the expense of farmers. So this policy was ultimately reducing export competitiveness for Cambodian farmers, and thereby contributing to poverty. Dilution of pharmaceuticals, including antibiotics, have become a major

¹ The Chairperson of the Working Group was Andrea Meloni of Italy, and the members of the working party are Australia, Canada, China, European Union, India, Japan, Korea, Malaysia, New Zealand, Singapore, Chinese Taipei, Thailand, United States and Venezuela.

public health concern. At the heart of both problems is the way Cambodia governed trading rights, which Cambodia has agreed to reform in its WTO discussions.

The process of becoming a WTO member has therefore improved prospects for farmers and consumers, at the expense of those firms and traders who either got licenses or tried to take advantage of the flaws of the licensing regime. The net gain from a development perspective is positive.

(3) What would be the advantages and disadvantages of joining the WTO?

There are many advantages to joining WTO, but I'm going to limit my comments to three advantages and three disadvantages.

Advantages:

- **Access to Markets.** By joining WTO, Cambodia will be treated by all members as a most-favored nation, and cannot be discriminated against unfairly according to the principles and rules underlying the trading system. This provides superior market access in a wide range of products and a wide range of countries – an achievement that would have been impossibly time consuming on a bilateral or even regional basis.
- **Capacity Building.** Leveraging the advantages of WTO required skilled public service, and informed public and a responsive private sector. Cambodia had a very capable negotiating team, judging by the results, and equally strong performances will need to be put in across the government and in the provinces. To support capacity building, Cambodia was one of three pilot countries to take advantage of Integrated Framework of Trade Related Technical Assistance (IF), which is a joint product of six international organizations including the Bank. Recently, a seminar on the Integrated Framework was held in Phnom Penh to build capacity of officials in Lao PDR and Cambodia, and a Khmer and English documentary on trade is being put together. The Ministry of Commerce is establishing inquiry points to allow those in foreign markets to more quickly understand Cambodia's trade policies and market structure, and the Cambodian private sector will be able to leverage trade "inquiry points" in oversea markets.
- **Governance.** As described above, reducing market distorting licenses and tariffs will eliminate a significant source of corruption. But the governance benefits go beyond Cambodia and beyond licenses and quotas. Many of the issues raised by the working party were about transparency and governance, and required responses such as listing its laws and regulations on websites, opening sectors like telecommunications to competition. Likewise, Cambodia will be able to scrutinize and challenge, through WTO rules, trade policies adopted by other nations.

Disadvantages

- **Adjustment.** Clearly there will be adjustment costs as Cambodia opens its markets to firms who hail from more competitive environments, and before Cambodia has had an opportunity to develop many of the institutions that support the private sector globally. The lack of commercial credit, legal infrastructure, logistics, market information networks, industry associations, skill development institutions, quality institutions, and

high costs of doing business ensure that many domestic firms cannot be immediately competitive. There will clearly be jobs lost in the short run, as imports displace some domestic production. The longer Cambodia takes to “level” the playing field, the more severe such adjustment problems will be.

- **Cost.** These obligations require Cambodia to spend considerable human and financial resources on reform. To take one area, implementing TRIPS by 2007 will require extensive review and possibly rewriting of Cambodian laws. In some cases the government may need to create new agencies or reorganize existing ones, procure specialized equipment, and increase training of government officials. These reforms will compete with other public policy priorities for scarce government resources. This is why Cambodia has received some phase-in and adjustment periods for many of its commitments.
- **Flexibility.** By joining a large organization with established rules and processes, there is an inevitable tradeoff in terms of freedoms to set policies, particularly those that might contradict the core values and rules of the organization. For example, Cambodia will no longer have the freedom to selectively offer access to its markets to a narrow set of countries at the expense of all other WTO members, or to offer high tariff protection beyond what was negotiated. The net result, we think, is very positive for Cambodia and much more positive if related reform areas are addressed.

(4) Who will benefit the most and who will be hurt the most from joining the WTO?

The largest beneficiaries from joining WTO are likely to be ordinary Cambodian citizens as consumers and the retail industries that serve them, who will face a greater choice and lower cost of imported products, and domestic products with some import content.

The second most important beneficiary will be the Cambodian private sector and the workers it employs, particularly as the investment climate improves and private sector-supporting institutions are put in place. But here the picture is a dynamic one that depends on further reforms and responses of the private sector to those reforms over time. We recently conducted a survey of 500 private enterprises – a productivity and investment climate assessment, and found that only 16% of the sample are actually exporters, but the vast majority import some part of their production inputs. Those that export or import intensively will benefit immediately. The benefits are also indirect – a more competitive telecommunications environment will lower the cost of telecom for everyone.

As we have explained in many of our workshops and programs over the past year, WTO accession means competition, and there will be winners and losers. We can place those at risk into two categories: those who may suffer from legitimate competition, and those whose survival to date has been based on policies that will change. Such firms would include enterprises that have been protected through licenses or quotas that will become obsolete. Some WTO agreements will help some and hurt others. TRIPS, for example, may hurt pirated CD sellers in the short run makers but help Cambodian musicians, or anyone who would like to put a brand on a product, in the long run.

As policymakers, the issue is ensure that the overall balance is positive. Fair competition creates productivity, which is the foundation of sustainable employment. But firms will need to work hard to succeed in such an environment. The garment sector has grown in part due to preferential access to the US market that will end in 2005, after which the sector will need to

compete directly against the world's garment powerhouses such as China whose industry is 200 times larger than Cambodia's. Success will depend on both improvements to the business environment and firm-level efforts. The good news is that Cambodian private sector is "young" and dynamic, and by establishing a competitive environment now, the authorities have ensured that it does not grow with many of the inefficiencies other countries are struggling to address. WTO also includes provisions that will phase out the beneficial quota arrangement.