

## **Can China Save Cambodia from the Global Economic Crisis?**

April 1, 2009

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Despite over a decade of steady economic growth, Cambodia remains one of the poorest countries in Southeast Asia. The economy is narrowly based on the garment industry, tourism, and construction, and the majority of the workforce continues to be engaged in subsistence agriculture. The government relies heavily on foreign aid and, increasingly, on overseas investment to stimulate growth and provide basic services to its people. In recent years, China has emerged as Cambodia's leading investor and donor and an increasingly important trading partner, making it a crucial player in shaping the country's future. So will the close relationship with China help Cambodia weather the global financial crisis? Or can we expect the economic slowdown in China to spill over into the Cambodian economy?

### **Cambodia and the global economic crisis**

Cambodia averaged an impressive 7% annual GDP growth between 1993 and 2004, largely stimulated by export growth in the garment sector. The economy picked up speed in the following three years, reaching a growth rate of 11% per year between 2004 and 2007. The global economic slowdown will inevitably put a break on this growth. The garment industry has been hit by declining demand from the US – Cambodia's main export market – while the previously booming construction industry suffers from economic slowdown in Korea, the main source of investment in this sector. Tourism has also seen cut-backs in 2008 owing both to the weaker world economy and political unrest in Thailand. While the agriculture sector could potentially offset some of these impacts, low productivity and limited investments make it exceedingly difficult for Cambodian products to compete in the global market.

Cambodia's Prime Minister Hun Sen predicts that the economy will continue to grow at around 6% in 2009. Other forecasts, however, are less rosy. The World Bank believes that GDP growth will slow to around 5%, while the Economist Intelligence Unit forecasts a growth rate of as low as 1%. These rates would translate into a 3% and negative 1% income per capita growth respectively (taking into account population growth) – small compared to 8% on average over 1998–2007. The International Monetary Fund is even less optimistic, warning that the economy will in fact contract 0.5%. The downward trend was already apparent in 2008 when Cambodia announced a GDP growth rate of around 7%, the lowest in the past six years. In the garment sector, 51,000 workers are estimated to already have lost their jobs or had their contracts suspended, while the International Labour Organization has predicted 25,600 job losses in the construction sector.

### **China as a source and driver of aid**

Overseas aid continues to make up a major share of Cambodia's budget, with donors seemingly undeterred by the government's failure to address widespread corruption and strengthen the rule of law. Indeed, one could be forgiven for thinking that the economic crisis was just a myth when looking at aid pledges to Cambodia at the annual Cambodia

Development Cooperation Forum in December 2008, at a time when the impacts of the economic crisis were already spreading around the world. The Cambodian government had asked for around \$600 million in support and received a staggering \$950 million in pledges – a substantial increase from nearly \$690 million the year before and the highest amount since 1994. This figure will increase even further once the US government's pledge is added which had been put on hold while the new administration was moving into the White House.

China has become a key source of foreign aid in recent years. The biggest pledge came in 2006 when China's Premier Wen Jiabao during a visit to Cambodia promised \$600 million in loans and grants to the government spread over several years, prompting Prime Minister Hun Sen to describe China as Cambodia's 'most trustworthy friend'. In 2007 China for the first time joined the Development Cooperation Forum and became the largest donor in 2008, contributing 27% of the total pledges followed by the EU (23%) and Japan (11%). China provides its aid mainly in the form of concessional loans, with a focus on infrastructure, public works and energy projects, including a number of major hydropower developments.

### **Aid, strategic and economic interests**

The economic and strategic interests at play in Cambodia's aid environment – and in particular the role of China in shaping these dynamics – suggest that aid will continue to pour in even as the global economy slows. For China, the aid clearly serves its economic and strategic interests (as aid often does). Concessional loans amounting to \$215 million for road construction promised in 2008, for instance, will facilitate the transport of raw material from Cambodia to China and help access some of the remote mining areas in the country's North and Northeast. China's aid also helps to prepare the ground for Chinese companies to expand oil and mineral exploration. A close relationship with Cambodia is also becoming increasingly important for China as it seeks to secure existing and find alternative transport routes for oil imports to reduce its dependence on the Straits of Malacca.

China's growing influence has Cambodia's traditional Western and multilateral donors worried. As the Cambodian government is able to diversify access to funds through China and expected (though still uncertain) oil revenues, Western donors are concerned that they will lose their influence in the country. Cambodia is an important partner in Southeast Asia as a generally pro-Western, stable country in a region with growing Islamic influence in Malaysia and Indonesia and political instability in Thailand. Cambodia could also become a useful regional base to project maritime power into the Gulf of Thailand and the Straits of Malacca. And just like China, the West is interested in Cambodia's natural resources. The petrochemical giant Chevron Corporation is already exploring for oil off the Cambodia coast while Australia's BHP Billiton is searching for bauxite in the Northeast.

### **Cambodia courts China**

Cambodia can be expected to continue courting China in the coming years. As Cambodia's Minister of Finance Keat Chhon put it, "China is more than just a good rich neighbour ... China knows what Cambodia needs". And China indeed is giving Cambodia what it urgently needs – roads and electricity – even if by doing so it serves its own interests. China's style of delivering aid, which goes directly to the highest levels of government with seemingly no strings

attached, obviously suits the Cambodian leadership and provides a welcome alternative to the conditionality attached by Western donors and multilateral aid agencies. Unrelenting aid flows from all sides allows the Cambodian government to play the various donors off against each other and thereby continue to stall on some of the much-needed domestic reforms. From a political perspective, the government also sees an opportunity in its close ties with China to strengthen its position in the region vis-à-vis the more powerful neighbours Vietnam and Thailand.

### **China as a source of continued investments**

Foreign direct investments in Cambodia have increased considerably since the early 1990s. Inflows reached a record high of 10% of GDP in 2007, but slowed in 2008 and, according to the World Bank, are projected to fall to just over 5% of GDP (or \$600 million) in 2009. China has become the biggest financier in Cambodia, investing \$4.3 billion in 2008 (ca. 40% of total), far ahead of South Korea, the next biggest investor with \$1.2 billion. Traditionally, Chinese investments have focused on the almost entirely Chinese-owned garment industry. More recently, Chinese investors are increasingly branching out into other areas, including agribusiness, energy projects and mineral and oil exploration. The China National Offshore Oil Company and China National Petroleum Corporation, for instance, are exploring for off-shore oil reserves and the China National Chemical Engineering Group Corporation is reportedly planning to build an oil refinery worth \$400 million in the coastal town of Sihanoukville.

In many cases, Chinese investment and aid (notably concessional loans) in Cambodia are hard to separate, as Chinese state-owned companies are usually contracted to implement the projects. Large-scale hydropower developments carried out by Sinohydro (whose \$260 million investment in the Kamchay dam is the biggest foreign investment in Cambodia to date), China Southern Power Grid and other Chinese companies, for instance, are backed by Chinese financiers such as the China Export-Import Bank and the China Development Bank. Interest free loans to reconstruct National Road 7 linking Cambodia to Laos and eventually China brought an \$80 million deal for China's Shanghai Construction to undertake the construction work.

### **China and the global economic crisis**

The global economic crisis has started to take its toll on China. Economic growth is slowing as global demand for manufactured goods decreases. Unemployment is on the rise; the government estimates that as many as 20 million workers (or 15% total) have lost their jobs as export-oriented industries are closing down. However, despite these trends, Cambodia might still be able to pin its hopes on China as a future source of investment. China is the only major economy not laden with debt and the government has adopted a massive stimulus package to keep the economy growing. The country can use its huge foreign reserves to support its state-owned enterprises – both directly through loans and indirectly through aid-financed infrastructure developments – to continue investing in natural resources overseas to supply its processing industry.

Indeed, despite the global economic turmoil, Chinese overseas investments nearly doubled in 2008 compared to the previous year, reaching just over \$52 billion. Chinese companies are said to be venturing out hunting for bargains as Western companies look for capital to stay afloat. The Aluminium Corporation of China (Chinalco), for instance, is seeking to invest \$19.5 billion in Rio Tinto while the Minmetals Non-ferrous Metals Company Ltd (Minmetals) has

launched a \$2.6 billion takeover of OZ Minerals. The China Development Bank has signed a deal with the China Petrochemical Corporation (Sinopec) and Petrobras worth \$10 billion in loans to the Brazilian oil company in return for long-term commitments to export oil to China. Cambodia may be one of the countries that can benefit from this trend.

### **Cambodia: 250,000 young people enter the job market every year**

Having said that, the quantity of foreign investments will not be sufficient to determine whether Cambodia can weather the global economic storm and ensure economic growth in the long term. To be economically and socially sustainable, investments will need to generate employment, increase linkages to the wider economy and enhance productive capacities. This is where major challenges remain. While foreign direct investment in Cambodia has contributed to job creation in the past, notably in the garment and tourism sectors, the current growth rates are unlikely to provide enough employment opportunities for the 250,000 young people entering the job market every year. Backward linkages to the wider economy remain extremely limited as most inputs for the garment industry and even the tourism sector are imported from overseas. Moreover, investments have generally not focused on enhancing productivity, which is most acutely felt in the severely under-developed agriculture sector.

### **Looking ahead**

Prime Minister Hun Sen has often been accused of pandering to China, but in the current economic climate, this strategy may just pay off – or at least in the short term. China not only plays an increasingly important economic role in the country, but its growing presence has also helped keep Cambodia on the radar screen of its Western partners. China's investments and aid, where they focus on infrastructure developments and electricity generation, could help address some of Cambodia's most pressing problems. However, China is unlikely to provide the investments needed to build Cambodia's productive capacities, instead seeking overseas contracts for its state-owned enterprises and natural resources for its domestic processing industries. By increasing its dependence on China, Cambodia therefore runs the risk of becoming even further locked into the role of a natural resource provider. Thus, rather than unconditionally opening its doors to China, Cambodia's long-term socio-economic development will depend on the Cambodian government's ability and willingness to channel financial resources into developing its own industrial and agricultural sectors. The aim is not to shut China out, but rather to identify and co-operate in areas where China's and Cambodia's development interests can be aligned.

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