

# PERSPECTIVE

RESEARCHERS AT ISEAS – YUSOF ISHAK INSTITUTE ANALYSE CURRENT EVENTS

Singapore | 30 May 2024

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## **Policies to Increase the Inclusiveness, Resilience and Sustainability of Economic Growth in Cambodia**

*Jayant Menon\**



*People working at the Jiangxi 3L Medical Products factory in the Sihanoukville Special Economic Zone (SSEZ) in Sihanoukville, Cambodia on Nov. 21, 2023. Photo by Liao Hongqing/XINHUA Xinhua via AFP.*

*\* Jayant Menon is Senior Fellow at ISEAS – Yusof Ishak Institute. He thanks Cassey Lee, Lee Poh Onn and participants at an ERDI Economics Seminar at the Economic Research Department at the ADB and the CDRI 2023 Cambodia Outlook Conference for useful comments, without implicating them in any way.*

**EXECUTIVE SUMMARY**

- To realise its aspirations to become an upper middle-income country by 2030 and a high-income country by 2050, Cambodia has to pursue inclusive growth that is also sustainable and resilient. This is the type of growth that generates decent and sustainable jobs in the manufacturing and services sectors, and fair and sustainable returns for the self-employed, in the formal and informal sectors.
- A key constraint is the lack of diversification of the economy. This has not affected the rapid pace of economic growth but only the inclusiveness and sustainability of that growth.
- The early phase of diversification involving rural-urban migration from the agricultural sector into the industrial and services sectors may be reaching its limit; future increases in productivity will have to come from intra-sectoral diversification. This involves the vertical shift into higher value-added products and activities within each sector.
- Intra-sectoral diversification requires that two key constraints be addressed. First is limited human capital, calling for improvements in the quality of education at all levels, starting with primary and secondary before technical and tertiary education. Second is the high cost of doing business, which stems from limited physical and logistics infrastructure, high energy cost, and the high cost of finance.
- Addressing these constraints should increase inclusiveness in economic growth.
- To ensure that these achievements are not short-lived, another set of constraints that affect resilience and sustainability need to be addressed: (i) climate change and other environmental pressures; (ii) financial, health and other shocks or crises; and (iii) technological change, especially the acceleration towards a digital economy.
- Improving the sustainability of growth and its drivers involve diversifying trade and investment flows.

## INTRODUCTION

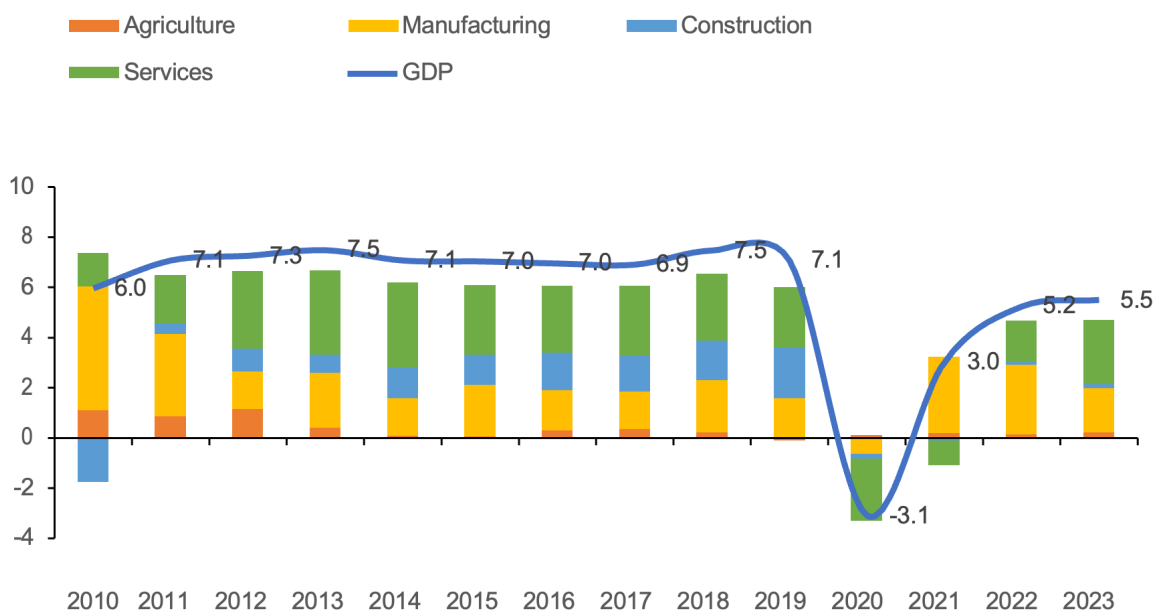
In many ways, Cambodia is Asia's true miracle economy. It was only three decades ago when the Paris Peace Agreements were signed, ending the civil war that ensued following the ouster of the genocidal Khmer Rouge regime in 1979. In just over a generation, Cambodia has built up its economy and institutions almost from scratch, and transformed itself into a modern, thriving economy. Although many challenges remain, these achievements should be recognised and bode well for the future.

Despite its tragic history, Cambodia has great aspirations. It aims to become an upper middle-income country by 2030 and a high-income country by 2050. To realise these aspirations, Cambodia has to pursue inclusive growth that is also sustainable and resilient. This type of growth should generate decent and sustainable jobs in the manufacturing and services sectors, and fair and sustainable returns for the self-employed, either in agriculture or in the micro, small and medium enterprises (MSMEs) across sectors, formal or informal. To do this, it has to address a number of constraints.

A key constraint, which is highlighted in the Royal Government of Cambodia's Rectangular Strategy (Phase IV) and the new Pentagon Strategy Phase I, is the lack of diversification in the economy.<sup>1</sup> Although highlighted in the ADB's (2014) Country Diagnostic Study (CDS), it continues to be a major constraint. The lack of diversification may not have affected the rapid pace of economic growth, but may have hindered the quality of that growth, particularly its inclusiveness and sustainability. Cambodia has been able to grow at above an annual rate of 7% since the turn of the century, except for the years afflicted by the Global Financial Crisis (GFC) and the COVID-19 pandemic (Figure 1). This high growth was mainly driven by trade preferences, tourism centred around Angkor Wat, and large capital inflows mainly from China into infrastructure and real estate. With Least Developed Country (LDC) graduation expected this decade, Cambodia will become a victim of its own success, and trade preferences and aid flows are likely to diminish. It will need to pursue new drivers of growth, which will require new and greater diversification.

The early phase of diversification or structural transformation, involving rural-urban migration from the agricultural sector into the industrial and services sector, has been ongoing but may be reaching its limit. This inter-sectoral transfer of factors of production is the easy phase of diversification, requiring minimal government intervention or policy reform, and takes place somewhat naturally with minimal disruption to factor markets (see Kaldor, 1967; Herrendorf *et. al.*, 2013). The horizontal shift across sectors into higher value products and activities produces a one-off increase in the level of productivity, which raises incomes and living standards; however, this increase may not be sustainable.

**Figure 1. Sectoral Contributions to GDP Growth, 2010–2023**  
(% year on year)



(-) = negative, GDP = gross domestic product.

Source: Asian Development Bank estimates.

Future increases in productivity will have to come from intra-sectoral diversification or specialisation within sectors. This involves the vertical shift into higher value-added products and activities within the industrial, services and agricultural sectors. This type of diversification is sometimes referred to as moving up the value-chain by engaging in higher value-added activities and in manufacturing, and is associated with greater participation in global value or supply chains. Unlike the early phase of industrialisation, this process of upgrading is unlikely to happen naturally and will require government intervention and/or policy reforms.

There are two major constraints that need to be addressed through policy reforms and government support to enable greater intra-sectoral diversification. The first is limited human capital and skills mismatches. Second is the high cost of doing business, which limits development of the private sector and domestic and foreign investment. Addressing these twosets of constraints should result in economic growth that is more inclusive. To ensure that these achievements are not short-lived, another set of constraints need to be addressed. This involves measures designed to increase resilience and sustainability, which would otherwise threaten current and future growth.

To address these constraints, three accompanying sets of policy reforms and government interventions are recommended.

## KEY CONSTRAINTS TO DIVERSIFICATION AND INCLUSIVE GROWTH

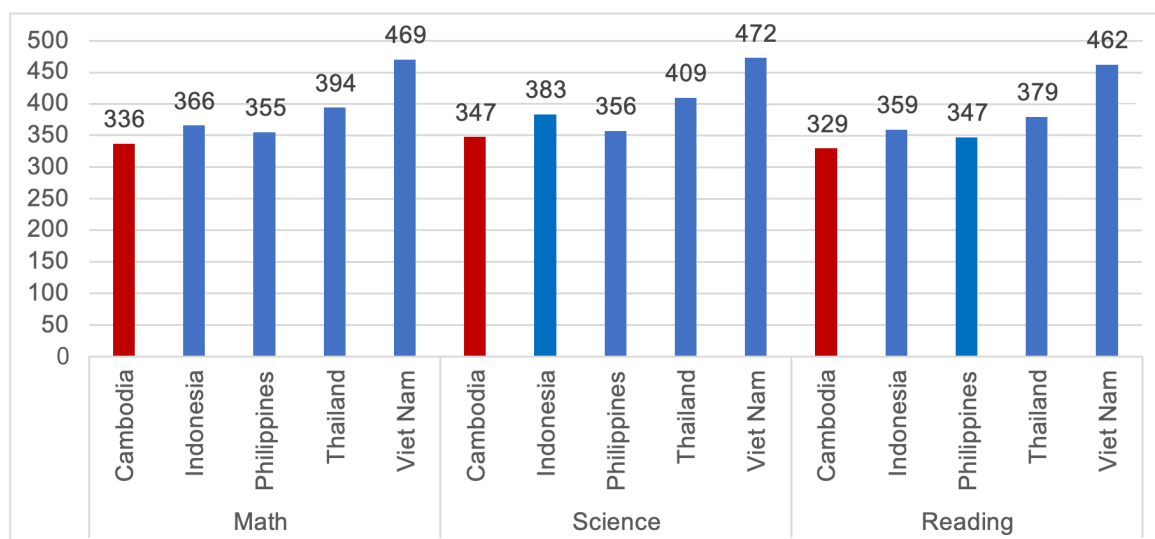
### *Human Capital*

Starting with the human capital constraint, there is an urgent need to improve the quality of education at all levels, and not just Technical and Vocational Education and Training (TVET) or tertiary education. TVET and tertiary education can only succeed if students have had a strong educational foundation in primary and secondary schooling. Results from the 2022 Programme for International Student Assessment (PISA) show Cambodia lagging behind its ASEAN peers in math, science, and reading despite improvement since 2017 (Figure 2). Similarly, Cambodia lags in the share of its labour force with advanced education (Figure 3).

Quality improvements also need to be accompanied by measures to improve access and retention rates, which are currently low. For instance, Warr and Menon (2016) found that more than 30 percent of new employees in the Japanese multinational firm Denso had never attended school, could not read or write, and had limited numeracy skills. Although firms like Denso were willing to provide their own tailored and on-the-job training, these workers were effectively untrainable and could only be employed to undertake the most routine of manual tasks.<sup>2</sup>

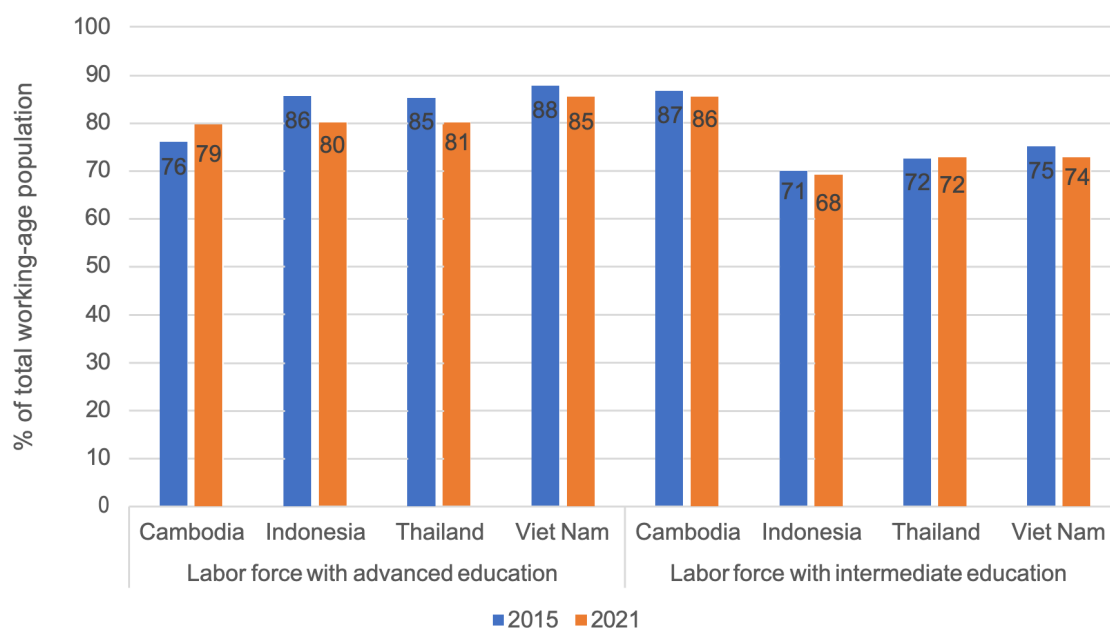
Cambodia needs to invest in skills development and training in close collaboration with the private sector to avoid skills mismatches. TVET and tertiary education institutions need to align their curricula more closely with the needs of the private sector. There is also a pressing need to address the various barriers and push-and-pull factors that limit access to formal employment, and strengthen social protection systems.

**Figure 2. PISA Scores for Mathematics, Science, and Reading at Age 15 Comparing Cambodia with Regional Peers, 2022**



Sources: OECD Programme for International Student Assessment (PISA) 2022; PISA 2022 Results, Volume 1, Reader's Guide, and Annex 4.

**Figure 3. Labor Force Educational Attainment, 2015 versus 2021**  
**(% of working-age population)**



Source: World Bank World Development Indicators (accessed 11 April 2024).

*Business Costs*

Second is the high cost of doing business, which stems from limited physical and logistics infrastructure, high energy cost, and the high cost of finance. For a developing economy like Cambodia that is rapidly transforming, transport and related infrastructure needs are a moving target. Despite notable achievements in building infrastructure, a deficit remains which continues to add significantly to business costs. There is a need to prioritise investments both within the transport sector, as well as economy-wide. Within transport, chokepoints such as port capacity, high-cost centres such as logistics infrastructure, and inter-modal connectivity should be prioritised.

Since infrastructure development relies on foreign involvement, increasingly from China through the BRI, there is a need for better vetting of project proposals through comprehensive cost-benefit analyses conducted by an independent body. It is time for the country to consider setting-up an independent Foreign Investment Review Board, operating as a non-statutory body with inter-ministerial and multi-stakeholder representation, to assess individual proposals in a purely advisory capacity. The inter-ministerial representation would ensure that sector priorities are considered in the approval process (see Menon, 2024).

The cost of electricity in Cambodia is one of the highest in the region, with a kilowatt hour costing USD 0.14 relative to 0.11 in Thailand and 0.08 in Vietnam. The high cost is limiting vertical upgrading within electronics and automotive supply chains, from labour-intensive assembly activities to higher value-added, energy intensive production of parts and components. Greater investment in renewable energy and energy efficiency is required to reduce costs as well as the reliance on diesel and heavy fuel oil in electricity generation.

Investment in grid extension and addressing the fragmented nature of transmission and distribution will reduce the cost of electricity. There is significant potential to scale up investment in solar energy, which could significantly reduce business costs for MSMEs that are off grid.

The high cost of finance, especially to small-scale farmers and MSMEs, perpetuates poverty (Karamba *et. al.*, 2022). Limited access to formal avenues of finance, with more than 70 percent of the population estimated to be unbanked, is closely related to its high cost. The potential for digital innovation, including fintech and blockchain, presents significant opportunities for Cambodia's financial sector to enhance financial inclusion. Increasing digital literacy and access to digital infrastructure, which is still low in the rural sector, is required to increase access of the poor to finance at a reasonable cost.

There are also a host of long-term development challenges that need to be addressed which will affect trust in the system, and therefore both the access to and the cost of finance. These include issues relating to governance and corruption, the quality of institutions including the legal system, and the development of the finance sector and capital markets.

## **LONG-TERM INCLUSIVE GROWTH: INCREASING RESILIENCE AND SUSTAINABILITY**

To ensure that growth is more inclusive not just in the short term but extends into the long term, there is a need to reduce the risk of disruptions while increasing the versatility in managing and responding to all kinds of shocks. Increasing resilience include addressing the impacts of: (i) climate change and other environmental pressures; (ii) financial, health and other shocks or crises; and (iii) technological change, especially the acceleration towards a digital economy. Improving the sustainability of growth and its drivers involve diversifying trade and investment flows; diversifying export products and markets and import sources, as well as sources of FDI flows, will reduce risk and increase the sustainability of economic growth. Policies and interventions to address each of these are discussed in turn, below.

### *Climate change and other environmental pressures*

Climate change threatens the livelihoods of millions as well as long-term aspirations such as reaching high-income status by 2050. ADB (2023) estimates that Cambodia's GDP could be up to 10% lower than otherwise in 2050.

While economic growth and environmental protection are often considered trade-offs, there can nevertheless be complementarity between them. The intersection between the two is greengrowth, where ecologically sustainable economic growth that fosters low carbon but socially inclusive development is the outcome. Green investments do not only unlock growth potential but also create decent and sustainable jobs for the future. There is significant potential to scale up investment in renewable energy and energy efficiency using Cambodia's solar energy resources.<sup>3</sup> Significant parts of Cambodia remain without access to electricity, and solar power carries the potential of transforming remote and often poor communities by providing them with affordable clean energy and the opportunity to improve living conditions

Transitioning away from the heavy reliance on fossil fuels, reducing the rate of deforestation and adopting more sustainable agricultural and fishing practices will be critical in protecting the environment and ensuring the future prospects of these industries.

As green and sustainability aspects of production become increasingly important in business and investment decisions of international firms, reducing Cambodia's carbon footprint would present it with new growth opportunities that arise from increasing global demand for environmentally sustainable products and services.

#### *Financial, health, and other shocks or crises*

##### *- Financial Risks*

Cambodia will need to strengthen its financial sector resilience by enhancing regulatory and supervisory frameworks, improving asset quality and risk management practices, and addressing weaknesses in the banking system. There is a need to implement regulations to deal with bank and debt restructuring, and corporate insolvency. Rising private debt following the slump in the property market has also become a concern that could threaten the stability of the economy and its future growth. The IMF (2024) notes that its share of GDP at around 160 percent is high for a country at Cambodia's level of development.

With the growth in shadow banking and the increase in non-bank financial institutions, greater regulatory oversight and supervision will be required. Cambodia's authorities will also need to accelerate work on a deposit protection scheme, implement measures to prevent money laundering, and clarify the framework for bank resolution.

Cambodia's authorities will need to carefully monitor the health of banks and microfinance institutions as the forbearance measures are phased out, especially the systemically important banks that have high exposure to the construction and real-estate sector. A staged increase in minimum capital requirements could also be used to promote consolidation in the banking and microfinance sectors.

##### *- Health crisis*

Although Cambodia did remarkably well in managing the COVID-19 pandemic, it highlighted a number of vulnerabilities in the healthcare system that need to be addressed before the next health emergency occurs. Government spending on healthcare needs to be significantly increased in preparation for the next pandemic or major public health outbreak.<sup>4</sup> This was a major limitation in managing the COVID-19 pandemic, requiring more stringent controls than in countries with more robust healthcare systems.

There is great variation in access to quality healthcare in the urban versus rural sector. There is a pressing need to increase both the access and the quality of healthcare in remote regions, that are currently poorly served. Unless there is greater investment to increase the quality and quantity of healthcare services, any future health crisis requiring mass hospitalisation could quickly overwhelm the healthcare system, inflicting a larger than necessary human and economic toll.



- *Technological change, especially the acceleration towards a digital economy*

The acceleration towards a digital economy will produce many benefits, but it will also create new challenges. Many low- and medium-skilled jobs may be lost initially, although Artificial Intelligence threatens even highly skilled ones. It will not be easy to redeploy low-skilled workers, and reskilling and retraining will be required. Despite the anti-globalisation backlash elsewhere, Cambodia must remain open to importing skills and technology to help it catch up in the short run. In the long run however, the challenges posed by digitalisation and rapid technological change will require a fundamental transformation in systems of education and learning. Indeed, the digital transition reinforces the need to address the underlying problems associated with human capital and skills development discussed earlier. Augmenting cognitive skills such as math's and sciences will be critical for the transition to a more innovative, knowledge-based economy. New and innovative approaches to public-private collaboration are also needed, particularly in areas such as research and development.

- *Diversifying export markets and import sources*

Cambodia's trade patterns – both the commodity and country composition of its exports and imports – are highly concentrated, raising its vulnerability to country- or commodity-specific shocks. As the major constraints to structural diversification such as limited human capital and high business costs are addressed, trade and investment flows will also diversify. For instance, if the price of electricity could be reduced, this could attract new types of FDI from different source countries, which would result in new types of output such as electronic parts and components. This alters both the commodity and country composition of exports and imports, helping to diversify trade and investment patterns. This is one of a number of indirect channels involving policy reform that can affect trade and investment patterns. The loss of trade preferences following LDC graduation will also help diversify export products and patterns naturally.

There are specific policy changes that can be pursued to deliberately diversify trade and investment flows, and directly improve its sustainability.

Preferences are also present in the many FTAs that Cambodia is engaged in that skew the commodity and country composition of its imports. The margin of preference (MOP) — the difference between preferential and Most-Favoured-Nation (MFN) rates — is still high for many tariff lines and across different FTAs in Cambodia. When MOPs are high, trade patterns can be distorted through trade diversion. It increases concentration of trade flows by diverting them from non-FTA partners to FTA partners. Trade diversion is also welfare-reducing because imports are no longer sourced from the lowest cost producer. Pursuing open regionalism through multi-lateralisation of FTA preferences – i.e., offering preferences to all countries on an MFN basis – is in Cambodia's national interest. It would promote domestic competitiveness and welfare, while reducing the concentration in trade patterns (see Menon, 2022).

*Diversifying sources of FDI*

Cambodia needs to attract FDI or incur external debt if it is to grow at a rate faster than that determined by its low domestic savings rate. There is a sustainability element associated with both FDI and debt. The need for long-term debt sustainability is widely recognised and better understood than the need to ensure that FDI inflows do not exceed absorptive capacity. The latter is associated with ensuring that external competitiveness of the tradable goods sector is not impaired by a sharp appreciation of the real exchange rate due to massive inflows of FDI, resulting in Dutch Disease-type effects.<sup>5</sup> The relevant point here is that an economy like Cambodia should be selective in its choice of projects, whether financed by foreign investment or borrowings, if it is to grow in a sustainable and inclusive manner. In addition, increasing the share of new investors that can help plug Cambodia into new markets and manufacturing global supply chains will support domestic structural changes by diversifying sources of growth.

**CONCLUSION**

Cambodia aims to become an upper middle-income country by 2030 and a high-income country by 2050. To realise these aspirations, Cambodia has to pursue inclusive growth that is also sustainable and resilient. A key constraint is the lack of diversification of the economy, which has so far not affected the rapid pace of economic growth but only the inclusiveness and sustainability of that growth. Diversification so far has involved rural-urban migration from the agricultural sector into the industrial and services sectors, but this process may be reaching its limit. The horizontal shift across sectors into higher value products and activities produces a one-off increase in the level of productivity; future increases in productivity will have to come from intra-sectoral diversification. This involves the vertical shift into higher value-added products and activities within each sector.

Two key constraints limit the extent of intra-sectoral diversification. First is inadequate human capital, requiring improvements in the quality of education at all levels, starting with primary and secondary schooling. Second is the high cost of doing business, which stems from limited physical and logistics infrastructure, high energy cost, and the high cost of finance. Addressing these constraints should increase the inclusiveness of economic growth.

To ensure that these achievements last beyond the short term, another set of constraints that affect resilience and sustainability need to be addressed. Increasing resilience includes addressing the impacts of climate and technological change, and reducing the risk of financial, health and other crises but, should they occur, also mitigating their worst impacts. Improving the sustainability of growth and its drivers involve diversifying trade and investment flows. This will reduce Cambodia's exposure to country-specific shocks and indirectly help with diversification of the economy.

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**ENDNOTES**

<sup>1</sup> Diversification or structural change has two dimensions: inter- and intra-sectoral. Inter-sectoral diversification involves changes to the shares of GDP accounted for by broad economic categories such as agriculture, industry, and services. As an economy develops, these shares tend to change naturally, with rural-urban migration resulting in agriculture shrinking and the other sectors expanding. Intra-sectoral diversification is much more difficult to achieve and involves specialization within each of the broad sectors. In both cases, diversification entails reallocating factors of production from less productive economic activities to more productive ones.

<sup>2</sup> These fundamental challenges in the education sector need to be addressed concurrently with the skills development challenges in order to reverse the pandemic's impact on employment.

<sup>3</sup> UNDP (2019) estimates that more than \$900 million investment opportunities in solar photovoltaic (PV) exist in Cambodia.

<sup>4</sup> There are currently only 0.7 hospital beds per 1,000 people, compared to 2.6 in Vietnam and an average 4.7 amongst the OECD countries.

<sup>5</sup> As noted earlier, the criteria used by the CDC in vetting FDI proposals for QIP status may be incomplete because it does not consider broader macroeconomic effects and is not analysed within a comprehensive cost-benefit framework. The proposed Foreign Investment Review Board could go a long way towards overcoming the limitations of the current process. A properly functioning review board could help avoid the kinds of projects that have left neighbouring Laos in severe debt distress.

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