

Cambodia's Post-COVID-19 Economic Recovery Through Structural Transformation

Blaise Kilian

1. INTRODUCTION

In 2020, the COVID-19 pandemic suddenly halted two decades of booming economic growth in Cambodia. While the crisis was an extraordinary conjunctural shock, it illuminated the structural limitations of a growth model that enabled Cambodia to lift millions of people out of poverty. Therefore, implementing the policy agenda to address these weaknesses became even more pressing.

This chapter puts into perspective some of the triggering factors for success and failures Cambodia encountered towards the lower-middle income status it achieved in 2015 and some of those it will experience while moving towards the upper-middle income status it aims to reach by 2030. Between these two milestones, COVID-19 can be seen as a magnifier of existing weaknesses and a catalyst for remedial policies.

This chapter, far from being academic, is mainly the result of the author's keen observations based on his experience as a public-private dialogue facilitator and his privileged position in observing Cambodia for more than two decades. Most private sector feedback shared here comes from in-depth discussions with entrepreneurs and foreign investors. Information and comments shared on policy matters come from available literature and interactions with senior representatives of various government institutions. Finally, facts and figures are supported by data published by Cambodia's multilateral partners and national institutions. Overall, this chapter attempts to summarize some of the mechanisms that underlie the many changes Cambodia has been experiencing, provide some understanding of its past and current structural transformation, and discuss the way ahead.

The first part describes the economic model that allowed Cambodia to experience steady socio-economic development for two decades. This development was possible due to policy choices and competitive advantages. The second part studies the limitations of this model built on a narrow base economy, a limited number of partners, and deep structural vulnerabilities. The third part illustrates how the COVID-19-induced crisis highlighted some weaknesses. The fourth part discusses the policy response to address these structural weaknesses. It provides the author's understanding of the necessary dynamics that would allow Cambodia to reach the next

level of its structural transformation in the context of a post-COVID recovery plan. The conclusion raises some of the challenges that need to be overcome if Cambodia is to succeed in its endeavor and resume fast growth towards the upper-middle income status it aims to reach in 2030.

2. CAMBODIA'S CURRENT ECONOMIC MODEL: STEADY GROWTH AND COMPETITIVE ADVANTAGES

2.1 Two Decades of Economic and Social Development

Following signing the Paris Peace Agreements in 1991 and organizing the general election in 1993, Cambodia engaged in accelerated liberalization and privatization of its socialist economy. While the 1989 Constitution transforming the People's Republic of Kampuchea (1979–1989) into the State of Cambodia had already recognized the free market and private property, the so-called Second Kingdom (since 1993) initiated the economy's structural transformation with the support of donors and the international community.

The first years of the Second Kingdom were uneasy, marked by factional fighting that ended in 1998 with a painful political stabilization and the ultimate disintegration of the Khmer Rouge. However, in 1998, conditions were finally in place to foster the model of development that prevailed for the following two decades.

Between 1998 and 2019, Cambodia's economic growth averaged 7.7 percent per year (World Bank, 2022a), placing the country among the fastest-growing economies in the world. Even more significantly, based on World Bank statistics, the Gross Domestic Product (GDP) per capita multiplied by six from USD 270 in 1998 to USD 1,640 in 2019.¹ Foreign direct investment (FDI) significantly contributed to this performance. In 2019, Cambodia was ranked the 15th country in the world with the highest rate of FDI as a percentage of GDP, at 13.5 percent (World Bank, 2019a).

Similar progress was also visible in the evolution of several social indicators. Life expectancy increased by 14 years during the abovementioned period to reach 70 – compared with less than 25 years during the war, just before the Khmer Rouge took over (World Bank, 2022b). About 80 percent of the population is now considered to be literate (UNESCO, 2015), a jump of 13 percent, while the rate of Internet use among the population in 2021 reached 60 percent against one percent in 2008 (World Bank, 2021a). These are just selected illustrations of Cambodia's tremendous social and economic progress since its ultimate stabilization at the end of the previous millennium. Other aspects of Cambodia's socio-economic transformations could be highlighted, including, for instance, changes in consumer behavior that reflect improved livelihoods.

Of course, the country still faces many challenges, such as the ever-growing gap between the rich and the poor, increased pollution, especially with the widespread use of plastic (UNDP, 2019), and deforestation. But overall, Cambodia has performed outstandingly well by most indicators. This track record is even more impressive if one looks back at where the country comes from - a shattered society that less than five decades ago was coerced into mass urban exodus, full-scale collectivization, starvation, the annihilation of human resources, and complete demonetization of its economy.

2.2 Achievement Through a Combination of Competitive Advantages

Cambodia's outstanding—yet under-publicized—performance has been achieved thanks to a combination of competitive advantages that can be grouped into three layers: political stability and sound macroeconomic management; a young, affordable workforce and a business-friendly environment; and the ability to access international markets for both goods and services.

Political stability and sound macroeconomic management were prerequisites for laying the foundations for two decades of economic growth and investment. Although it is also put forward as a slogan, “peace and stability” has provided the necessary context for the political leadership to design and adopt an enabling regulatory framework within which investors could place enough trust to establish, run, and grow their businesses. Cambodia's history is a testimony to the limitations of an unstable political landscape on economic development. Stability also means predictability, and predictability is paramount in a rapidly emerging economy to build the trust of the private sector.

With political stability, the country could tame its inflation and exchange rate at levels that have remained the same until today. This was a remarkable achievement as the previous decade had been marked by high inflation, first as a result of a monetized deficit following the collapse of Soviet financial support at the end of the Cold War, with the inflation rate averaging 90 percent between 1989 and 1992 (Slocomb, 2010). Then, because of a massive inflow of US dollars during the 1992-1993 mandate of the United Nations Transitional Authority in Cambodia (UNTAC), which brought in approximately USD 2 billion in a country (Vouthy, 2012) whose GDP was estimated to be only USD 2.5 billion in 1993 (World Bank, 2022c). By 1998, however, the exchange rate was stable while the consumer price index was maintained below 5 percent from 1999 onwards – except for a short-lived hike in 2008 in the context of global instability.

A long-term economic consequence of the UN intervention was the dollarization of Cambodia's economy. While dollarization was not a policy choice for Cambodia but rather the result of historical events that culminated with the UN presence, it

nonetheless brought some benefits as it reassured investors by considerably reducing the exchange rate risk in a potentially volatile political and economic environment. It, therefore, played a role in the initial stabilization of the economy and is still a factor of attractiveness for foreign investors, even though it limits the scope of the country's monetary policy.

Beyond the pros and cons of this unexpected dollarization and the stabilization of its prices and exchange rate, Cambodia has also been described by multilateral financial institutions as soundly managed from the macroeconomic perspective. Until 2020, the fiscal deficit was under control, and the debt-to-GDP ratio was kept below 30 percent while international reserves stood above the minimum requirement for an emerging economy (World Bank, 2021b). Even the shock induced by the COVID-19 pandemic has not dampened the overall positive appreciation of Cambodia's fiscal management by multilateral partners (IMF, 2021).

On top of the solid foundation of political stability and sound macroeconomic management, Cambodia has capitalized on structural advantages resulting from its demographic and business-friendly environment. From a demographic perspective, the Cambodian population is very young, with approximately 60 percent aged less than 25 years (UNICEF Cambodia, 2019). Owing to low wages, this abundant young population has remained affordable as a workforce, enabling Cambodia to position itself as a competitive recipient of foreign investment in labor-intensive industries. Foreign investors consistently ranked labor costs as one of Cambodia's main competitive advantages (EuroCham, 2015; EuroCham, 2017b; EuroCham, 2019b).

The Royal Government of Cambodia took a pro-business stance on the economic policy front. The Investment Law adopted 1994, amended in 2003, and again in 2021 exemplifies the country's willingness to attract foreign direct investment. Furthermore, the structural adjustments adopted as part of the IMF support program since 1994 have focused on the liberalization and privatization of the formally socialist economy (Slocumb, 2010). Among the measures adopted by the Government to position Cambodia as a foreign direct investment-friendly destination are the possibility of registering a 100 percent foreign-owned company, the creation of a one-stop window for investors with the establishment of the Council for the Development of Cambodia (CDC); the absence of discrimination against foreign investment in most sectors; the lack of foreign exchange control and price control; and a relatively moderate tax framework have been notable factors of attractiveness. Other vital regulations include adopting the Law on Banking and Financial Institutions in 1999. Admittedly, many issues remain, including weak enforcement of the legal framework and the lack of transparency, but overall, Cambodia has marketed itself as a pro-business economy where the level of public-private dialogue is among the highest in ASEAN (EU-ASEAN Business Council, 2018; EuroCham,

2016a; EuroCham, 2017a; EuroCham, 2019a). The Government-Private Sector Forum exemplifies this for public-private dialogue with more than a dozen sectoral working groups, each co-chaired by a representative of the Royal Government and an elected representative of the private sector.

Finally, Cambodia secured privileged access to international markets for its industries and services. The European Union (until 2020, see below) and the USA granted preferential market access to Cambodia's goods, a critical factor in attracting foreign direct investment and the launching pad for the garment and footwear manufacturing sector that today represents the most significant part of the country's employment, industrial production, and exports. Cambodia also resolutely joined the World Trade Organization (WTO) in 2004, another step showing its commitment to an open and unrestricted market economy that was reassuring for foreign investors.

On the services side, the inscription of the world-famous Angkor Heritage Park on UNESCO's World Heritage List in 1992, the adoption in 2000 of an open-skies policy making Siem Reap-Angkor an international airport, and a visa-on-arrival policy for several countries opened the door to millions of international arrivals. It made the tourism sector the second biggest employer in the economy. In nearly two decades, international tourist arrivals multiplied by 13 to reach 6.2 million in 2018 (Ministry of Tourism, 2019).

This combination of competitive advantages, political maturation, historical accidents, sound policies, and a purposeful opening to the world allowed Cambodia to champion growth and lift millions out of poverty within two decades (World Bank, 2019b). In 2015, the country fulfilled the World Bank's conditions to attain the lower middle-income status, and the Government openly stated its ambition to reach the upper middle-income status by 2030. Figure 4.1 shows Cambodia's competitive advantages.

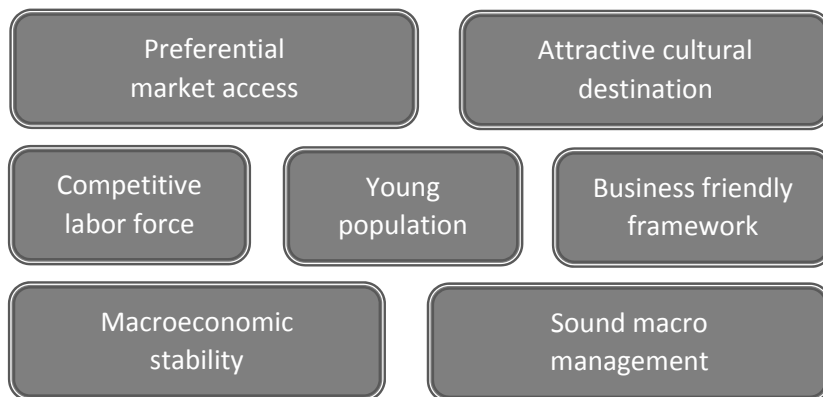


Figure 4.1: Cambodia's Combination of Competitive Advantages

The question, however, is to what extent this model that primarily relies on FDI-driven, cheap labor-intensive, and narrow-based industries can still serve its purpose in an economy that is being transformed by the day.

3. STRUCTURAL LIMITATIONS

Capitalizing on its competitive advantages, Cambodia attracted high levels of foreign direct investment, developed export-oriented industries, and fostered a thriving tourism industry, thus fueling two decades of outstanding economic growth. This growth has only slowed twice in twenty years: Following the global financial crisis in 2009 with a zero-growth rate and the unexpected shock resulting from the COVID-19 pandemic with a recession of -3.1 percent in 2020 (World Bank, 2022d). However, the Cambodian growth model contains limitations that became particularly visible during the 2020 recession. The steady growth of the past two decades has been highly dependent on a narrow base and a limited number of international partners. At the same time, a vast array of structural weaknesses hinders Cambodia's ability to reach the next level.

3.1 A Narrow-Based Economy

Cambodia's GDP growth has been driven by the garment, textile, footwear (GTF), and tourism sectors, which are considered the largest employers. A third contributor is agriculture, whose share in terms of value and employment has been continuously declining. A fourth sector is real estate and construction, whose contribution to the GDP has sharply risen to represent one-third of economic growth in 2019 (NBC, 2019).

Having secured preferential access to the US and European markets, Cambodia attracted a pool of Asian investors who set up factories to supply major global brands selling their products in Western markets. The garment and footwear manufacturing sector quickly became the largest employer in the economy, with about 880,000 workers in more than 600 factories² generate more than 70 percent of Cambodia's total exports (NBC, 2018). Likewise, the tourism industry grew exponentially following the launch of the open-skies policy in 2000. The second largest employer in the economy, the tourism sector, accounted for 630,000 jobs in 2019 (ADB, 2017; ADB, 2021a) and contributed around 32 percent of the GDP (OECD, 2018).

Agriculture before COVID-19, on the opposite of the two other sectors, had been declining both in the number of jobs and contribution to the GDP, with sectoral growth averaging only one percent between 2013 and 2017, down from 4.5 percent between 2008 and 2017 and 7 percent between 2003 and 2007 (OECD, 2018). While Cambodians are traditionally rural dwellers, agriculture could never

live up to its potential and has yet failed to modernize (Slocomb, 2010) even though the country exports rubber and, more recently, rice. Processing and certification capacities are lacking; irrigation has been slow to expand, and little value is created while the market is disorganized with informal middlemen exfiltrating large parts of the output of the main crops to be processed in neighboring countries; indeed, the Asian Development Bank estimates that “only about 10 percent of Cambodia’s total agricultural outputs are processed within the country, whereas processed agricultural exports represent only 8 percent of total exports by value” (ADB, 2021b). As a result, the sector remains weather-dependent, and its contribution to the GDP could be more moderate, sometimes negative, as it can hardly export processed products that meet the standards requirements of international markets. It continues to play a buffer role in crises when laid-off workers can return to their family households in the provinces, as observed during the COVID-19 pandemic in 2020-2021.

Finally, the construction sector’s contribution increased sharply, representing about one fifth of the country’s economic growth and 220,000 jobs in 2018 (NBC, 2018). This growth has been fueled by both local and foreign investment, especially from China, with a risk of vast speculative projects,³ but also to answer the demands of an emerging middle class and the needs generated by a rapidly growing population and rural exodus. The urban population increased from 19 percent in 2000 to 25 percent in 2022, with a significant acceleration from 2008 (World Bank, 2022e). While some segments may be oversupplied, and quality varies considerably from one development project to another, professionals in the sector believe that a long-term combination of demographic and economic growth will ensure sustained demand for real estate.⁴

Overall, the most significant part of Cambodia’s GDP and employment has relied on a narrow base of only three sectors: Export-oriented garment and footwear manufacturing; tourism-focused essentially on the Angkor World Heritage site; and a recent construction boom. Just before the pandemic, these three sectors were estimated to contribute 70 percent of growth and 40 percent of jobs in Cambodia (World Bank, 2020a). While agriculture remains an essential component of the economy, its declining contribution and slow transformation keep it apart from the three other sectors – despite some exciting initiatives such as Kirisu Farm.

Consequently, when the garment and tourism sectors, and to a lesser extent the real estate and construction sector, suffered external shocks generated by the COVID-19 pandemic, the Cambodian economy shrunk by 3.1 percent. Cambodia’s extraordinary resilience also met the crisis, but it reflected its strong dependence on a narrow economic base. By comparison, while ASEAN as a region entered a recession in 2021, the economies of Vietnam and Lao PDR kept growing slower (ASEAN Secretariat, 2021). Furthermore, Cambodia’s growth model already displayed inherent weaknesses that constrained the potential for future expansion.

3.2 Relying on a Limited Number of Partners

The drivers spurring Cambodia's rapid economic growth depend on a limited number of partners in terms of input and markets. Indeed, the sources of Foreign Direct Investment (FDI) that have enabled the garment and footwear manufacturing sector's expansion, as well as a large part of the construction boom, point to a strong dependence on Chinese investors (Figure 4.2), who represent more than 40 percent of the total FDI in Cambodia, not even mentioning a 20 percent share from Hong Kong (World Bank, 2020b). Likewise, almost 40 percent of Cambodia's imports came from China in 2016, especially for the inputs necessary for garments and footwear production, and 32 percent of tourists arrived from China in 2018. This dependence on China, especially as a source of FDI, has often been stressed by observers, particularly multilateral institutions and Western analysts.

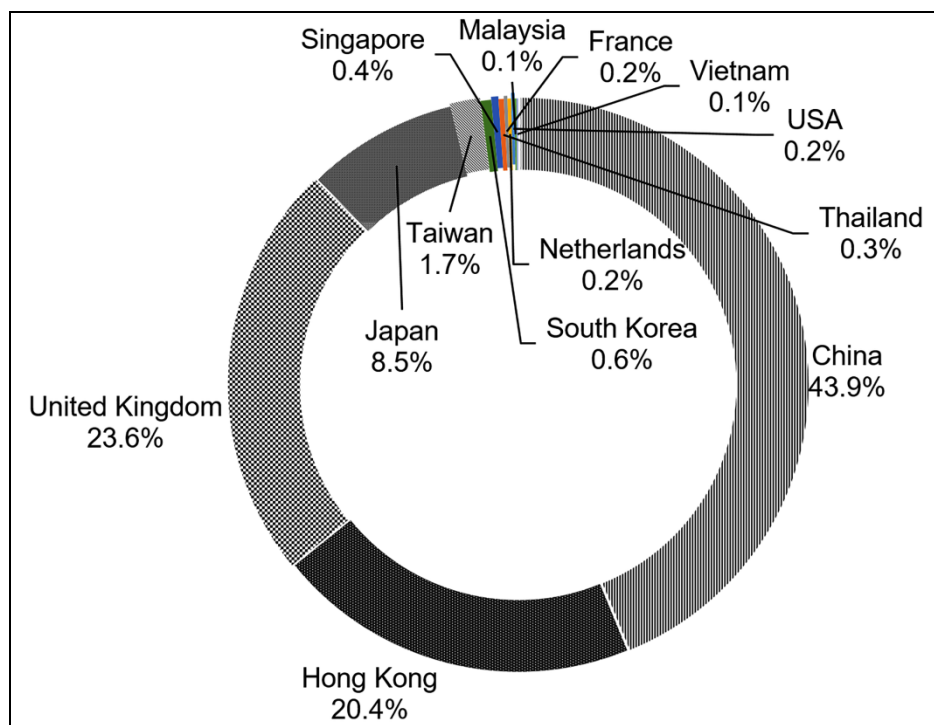


Figure 4.2: FDI Per Country of Origin (World Bank Economic Update 2020)

In addition, the dependence in terms of export markets is also very high, this time towards the European Union (EU) and the USA (Figure 4.3). In 2016, before the removal of the Everything But Arms (EBA) preferential scheme granted by the European Union, 35 percent of Cambodia's goods exports were destined for the EU and 21 percent for the USA (EuroCham, 2018a). Therefore, as of 2016, 56 percent

of the Kingdom's exports went to an economically synchronized and politically homogenous area. Beyond the risk brought upon by a potential conjunctural crisis in Western markets, the political dimension should also be considered, particularly when looking at the intensifying policy of sanctions adopted by the West towards countries that do not fit their political values. The temporary suspension of Cambodia's preferential access to the European Union market under the EBA trade scheme (European Commission, 2019) and the "high risk" advisory issued by the US State Department against investing in Cambodia (US Department of State, 2021) are testimony to the risk of depending only on Western partners while the political systems are not aligned.

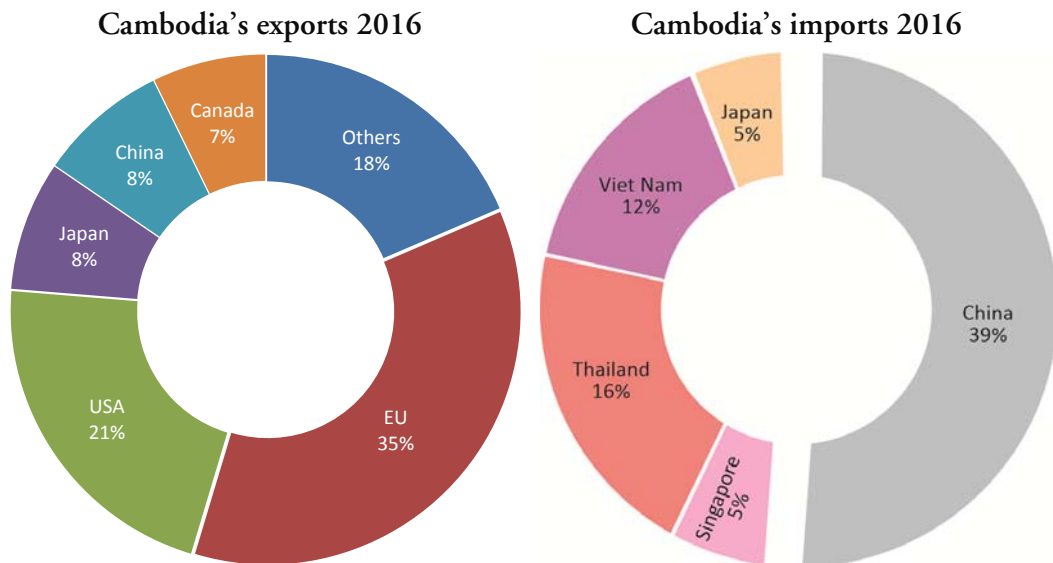


Figure 4.3: Imports Sources and Exports Destination (EuroCham Cambodia)

The question is about something other than reducing foreign direct investment originating from one country or the amount of exports directed to another country. It is about increasing other sources of investment and export markets to diversify partners and reduce the conjunctural and political risks inherent to dependence on a limited pool of investors, suppliers, and buyers.

3.3 Fueled by a Model that is Reaching Its Limits

While the economic model described above has served its purpose in enabling Cambodia to reach the lower middle-income status in 2015, it nonetheless contains inherent weaknesses that structurally limit the country's ability to continue growing towards its objective of becoming an upper middle-income economy by 2030.

According to EuroCham, the private sector's feedback gathered through surveys and public-private dialogue reveals a series of broad issues that need to be tackled to further the full potential of the Cambodian economy. Indeed, as the economy grows and becomes more sophisticated, solving these structural issues becomes a growing necessity. Three main categories look at the main structural issues that restrain the potential for future economic growth: quality issues, cost issues, and playing field issues.

The first broad category of issues concerns quality deficiencies that hinder productivity and increase value-addition. Among these, the availability of human resources is regularly cited by the private sector, especially foreign investors, as one of the main challenges of doing business in Cambodia, with the lack of skills being one of the reasons for this. Indeed, while reforms have been undertaken by the Ministry of Education, Youth, and Sport over the past few years, primarily to raise the standards in high school and to promote Science, Technology, Engineering, and Mathematics (STEM) in the education system, much remains to be done, especially in public schools. On the higher learning side, there remains a lack of adequation between the curricula offered to learners and the needs of the private sector regarding recruitment, contributing to what has commonly been called the "skills gap" (ADB & ILO, 2015). With limited skilled human resources, it is challenging for the private sector to increase productivity unless the company invests in additional training. Furthermore, the general need for standards in management and processes results in low-quality goods and services that leave no prospects for creating value-added. On the government side, the bureaucratic procedures and public services to the private sector, for instance, related to labor and tax matters, are also signaled by the private sector as impacting the ease of doing business in the Kingdom. Only some ministries can boost a level of competencies equivalent to the one that can be found in the most efficient private sector companies.

The second category of issues concerns the pressure put by various costs on the profitability of businesses. With twenty years of almost consecutive growth, wages have regularly increased, especially in the garment and footwear industry, where a minimum wage system is set by law and negotiated every year between representatives of the employers, workers, and the Government. While the low cost of human resources remains one of Cambodia's top comparative advantages, such a regular wage increase in the context of limited productivity puts pressure on the businesses' profitability. Despite recent improvements, the private sector considered the rise in cost, especially electricity and logistics fees, as an additional burden compared to the rest of ASEAN (OECD, 2018). An extra layer impacting profitability is the wide range of informal fees and non-transparent practices whose continued existence makes other costs less tolerable. In a general context of limited access to finance, the persistent issue of high costs impacts businesses' decision making and development prospects.

The third category of issues is related to the complaints by the private sector, especially but not exclusively foreign investors, against unfair competition and the general feeling that Cambodia could do better as a level playing field (Figure 4.4). Most of this feedback concerns an unsmooth interpretation of regulations, the need for coordination among state agencies, and measures not taken against uncompliant businesses. Unfair competition regularly stands at the top of obstacles to doing business raised by the private sector. In thirty years, the landscape of doing business in Cambodia has been transformed from a time when the legal framework was both limited and mainly unimplemented to a time when compliance and the expansion of the formal economy are becoming a priority for the Government. Indeed, the necessity to manage an increasingly diverse range of business activities (born from the multiplication of segments and emancipated consumer behavior) and to collect more taxes from substituting domestic revenues for foreign aid has opened the door to expanding the legal framework and tighter implementation of regulations. In the tax and customs areas, registration, audits, and penalties are on the rise, with the private sector complaining that voluntary compliance too often leads to punitive audits and penalties. At the same time, many non-compliant businesses can still “get away with it.” Additionally, the multiplication of new regulations and the now tighter implementation of previously existing ones have led to increased gaps in the interpretation of the law between the private sector, the regulators, and the civil servants, a matter of concern in an environment where compliance matters more than ever.

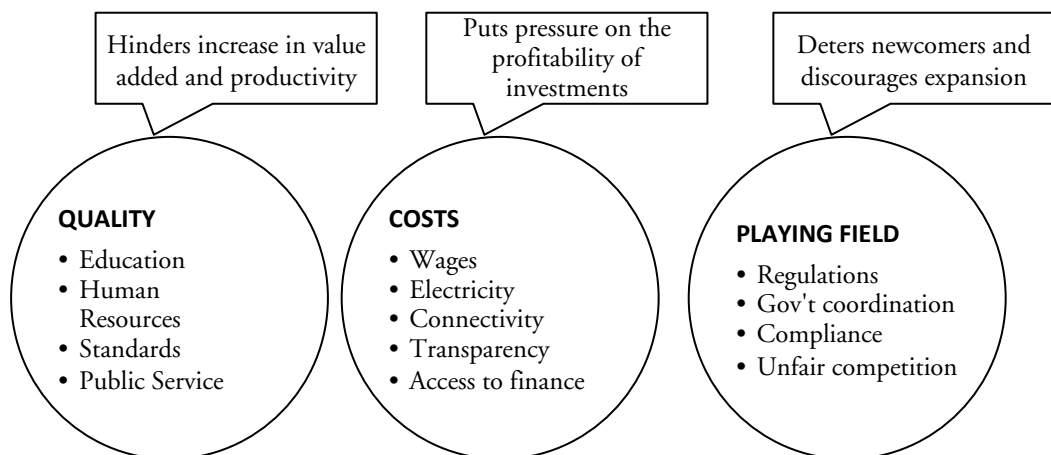


Figure 4.4: Cambodia's Structural Challenges

Beyond the abovementioned issues impacting Cambodia's attractiveness as an investment destination, additional observations offer a broader perspective on the Kingdom's economic landscape.

The first observation concerns the limited diversification of Cambodia's export-oriented industrial production. For more than two decades, Cambodia has focused on promoting cheap labor-intensive export industries that can be summarized as garment and footwear manufacturing. As of 2015, only 5.6 percent of Cambodia's manufactured exports were made of non-garment and shoe products (CDC, 2021).

A second observation is related to the quality of Cambodia's exports, whose medium and high-tech proportion remained below 10 percent as of 2019 (CDC, 2021). The Cambodian garment industry is based on the Cut-Make-Trim model, which implies that most of the inputs are imported to be assembled onsite in labor-intensive factories employing low-skilled workers. Overall, the domestic component of value added in the Cambodian exports does not exceed 10 percent, leaving a considerable margin for increase should techniques, skills, and local inputs improve. While this can be considered a regular pattern in the increased global integration of an emerging and export-driven economy, it also points to the almost complete absence of domestic backward linkages in the Cambodian economy⁵ and, by extension, to the inefficiency of the domestic industry landscape.

A third observation concerns the vast landscape of informal small and medium enterprises that must be fully accounted for in growth and employment figures. Indeed, in 2016, it was estimated by the Ministry of Industry, Sciences, Technology and Innovation (MISTI) that only 64 percent of small enterprises and 83 percent of medium enterprises were duly incorporated (CDC, 2021). These figures may need to be more accurate as it is always risky to assess what one cannot count, and also because some businesses may have registered with other authorities than MISTI. However, they give an idea of the proportion of the informal economy in the SME landscape. While they represent a considerable number of jobs and activities, the non-registered small and medium enterprises are managed with shallow standards for everything related to corporate governance, bookkeeping (according to the General Department of Taxation, only 13 percent of small enterprises had basic bookkeeping, and 35 percent of medium enterprises had a balance sheet in 2016 (CDC, 2021), labor, skills, production processes, product quality, certification, and others. Thus, they could be more efficient. This vast landscape of informal, substandard, and low-skilled SMEs needs to be connected to the most dynamic parts of the formal economy.

This disconnection between the formal and informal economy also explains the high level of import dependence that characterizes the more dynamic, foreign investment-driven, and export-oriented industries, as it makes domestic backward linkages almost impossible. The standard requirements of an industry that exports to more advanced markets are too high for substandard informal industries to supply local inputs or services. Inefficiency hinders the potential for growth and the creation of local value added. Admittedly, raising the standards of this SME landscape would not

only increase the size of the economy and earn more revenue for the State but also open the way for creating more value in the economy.

On the services side, the tourism industry also showed limitations. Efforts have been undertaken with mitigated success to diversify Cambodia's offer as a destination by promoting the coastline (15 percent of international arrivals in 2017), ecotourism areas (a long-proclaimed but hardly achieved objective with only 2 percent of international arrivals in 2017), and new heritage sites inscribed on the World Heritage List such as the Temple of Preah Vihear and the ancient capital-city of Sambor Prei Kuk. Despite these efforts, most of the 6 million tourists who visited the Kingdom before COVID-19 still went straight to Angkor, with the Siem Reap International Airport accounting for 60 percent of international arrivals by air in 2017 (World Bank, 2017).

This lack of diversity, compounded by limited infrastructure for travel and accommodation throughout the country,⁶ could be a reason for the persistently short duration of stay, which remained below one week before COVID-19 and even declined between 2013 and 2016, as did the average daily spending (World Bank, 2017) in a possible illustration of the usual interrogation raised by the tourism industry: "what to do besides the temples?" Regardless of COVID-19, tourism visitors and revenue growth had already decelerated in 2019, another indication of the difficulty for the tourism sector in keeping up with the booming pace of the previous decades.

An estimated 40 percent of generated revenues are lost through excessive reliance on imported human resources, services, and products. The high proportion of leakages is another weakness restricting the tourism industry's contribution to national wealth (World Bank, 2017). This issue is connected to the abovementioned challenges, such as the skills gap, the lack of standards requirements in goods and services, and the dependence on foreign investors and supplies.

Like in other sectors, a fair share of tourism businesses needs to be registered and, therefore, stays off the authorities' radar. Most of the hotels and guest houses below four stars are believed to be either entirely or partially unregistered with the Ministry of Labor and Vocational Training, the General Department of Taxation, and even the Ministry of Tourism.⁷ While standards are higher in this sector as it is necessary to satisfy millions of foreign visitors every year, the next section of this chapter will show how the low registration rate proved to be doom when the COVID-19-induced crisis hit the Cambodian economy.

While Cambodia has achieved outstanding socio-economic development on all fronts, the growth model on which it has relied for more than two decades contains inherent limitations that question its ability to continue growing at the same pace. Before looking at the structural transformations that will allow us to overcome these

limitations, it is interesting to examine how the crisis induced by the COVID-19 pandemic highlighted these weaknesses.

4. COVID-19 HIGHLIGHTED WEAKNESSES

4.1 Growth Drivers on a Halt

In late January 2020, Cambodia reported its first case of COVID-19. The entire economy soon suffered the consequences of the global slowdown triggered by the pandemic. The main growth drivers stopped, unemployment shot up, and the country entered a recession.

On the garment and footwear manufacturing front, Cambodia suffered from two shocks. First, its supply of inputs was disrupted due to lockdowns and restrictions imposed in China. The Cambodian Government, however, was quick enough to capitalize on its privileged relations with Beijing to secure emergency supplies for the garment industry (Lancang-Mekong Cooperation, 2020). While this issue seemed to be solved, demand from the Western markets dived due to the global slowdown and transportation bottlenecks. Orders books remained empty for 60 percent of factories (World Bank, 2020a), with buyers pressuring for lower prices in a sector already perturbed by the prospect of losing the EBA preference. Within a few months, Cambodia's aggregated exports of goods plunged, including for the burgeoning travel goods markets that represented a promising option of diversification and higher value added.⁸ Just three months after the global outbreak, more than 50 factories had closed, and 35,000 jobs had been suspended or terminated. By July, the Garment Manufacturing Association of Cambodia (GMAC) announced the suspension of 400 factories and the loss of 150,000 jobs, with many more at risk (Vantha, 2020). In January 2021, the estimated suspension of 526 factories impacted 349,000 workers (RGC, 2021).

The shock was even more severe in the tourism sector, with an almost complete halt of international arrivals. During the first two months of 2020, tourist arrivals to Cambodia contracted by 25.1 percent, including a decline in 45.6 percent of tourist arrivals at Siem Reap during the first quarter of 2020 and a 99.6 percent contraction in April 2020 (World Bank, 2020b). By March, one hotel out of four was closed in Siem Reap, and dozens of thousands of workers were laid off. The tourism industry entered panic mode, with multiple calls for the Government to intervene and avoid a complete devastation of the sector.

The real estate and construction sector did not feel the full impact of the crisis before 2021 but also saw a significant segment slowdown in 2020, with the boom of the past years coming to a halt. Construction permits contracted 9 percent against a 98 percent growth the year before. Imports of construction materials also contracted

(World Bank, 2020a), an announcement that the crisis would last until 2021 in this sector.

With its three primary drivers impacted, Cambodia's economy shrank by 3.1 percent in 2020, only saved by agriculture. While growing at its usual low rate, the latter played a vital buffer role, absorbing part of the hundreds of thousands of laid-off workers who could travel back to their family households in the provinces.

4.2 The Difficulty of Salvaging Businesses that do not Exist

The recession highlighted the danger of Cambodia's dependence on a narrow base and the precarity in which the large informal segments of the economy would find themselves in times of crisis. With Cambodia being one of the ASEAN countries where public-private dialogue is the most dynamic (EU-ASEAN Business Council, 2018), business and industry associations quickly contacted their government counterparts. Calls were made for extraordinary measures to prevent irreversible damage to sectors that had benefitted from decades of investment (EuroCham, 2020). There were intense discussions to find solutions and protect businesses and employees from a complete collapse. The Ministry of Economy and Finance was a main interlocutor of the private sector and coordinated the elaboration of 10 rounds of measures adopted over two years to ensure the survival of businesses in the most impacted sectors. The National Bank of Cambodia was also actively engaged by encouraging voluntary loan restructuring within the banking system and liquidity-providing measures (The Banker, 2020).

The most critical fiscal measures adopted to support the private sector in facing the dire consequences of the crisis included short-term tax exemptions that were regularly renewed and subsidies to suspended workers. These measures were applied only to the most impacted tourism and garment manufacturing sectors. In addition, the provision of preferential loans and co-financing schemes to SMEs was ensured through the SME Bank, established in 2020 by the Ministry of Economy and Finance, to answer the short-term needs related to the crisis and address the broader issue of limited access to finance for entrepreneurship. Other subsidies also took place beyond the private sector in cash transfers to the poorest.

While these measures did help to soothe the financial pain of their beneficiaries, whether these were business owners facing working capital asphyxia or suspended workers whose salaries had been partly or entirely lost to the crisis, they could only be of help to those who stood within the sphere of the formal economy. Indeed, nonregistered businesses and undeclared employees could hardly apply for government support since they legally did not exist. The issue was particularly true for the tourism industry, where the level of compliance has historically been shallow. As the pandemic-induced crisis climaxed in Siem Reap, only about 10 percent of

hotels had applied for tax exemption to the Ministry of Economy and Finance or employees' subsidies at the Ministry of Labor and Vocational Training. Indeed, nonregistered businesses and their employees discovered that while tax evasion could be comfortable in times of prosperity, it also excluded them from any rescue package in times of crisis. COVID-19 thus provided yet another pressing reason to expand the size of the formal economy.

Likewise, while the recession particularly wreaked havoc on the tourism industry, with nearly all the hotels in Siem Reap closing and their workforce being disbanded, it was difficult for the Government to make a precise assessment of the damages inflicted since many impacted businesses were not registered and were therefore off the Government's radar. For instance, in July 2021, the Minister of Planning suggested that 3,000 businesses had closed and 45,000 employees had lost their jobs in the tourism industry, an estimate that the private sector considered below reality. However, in the same interview, the Minister evoked the gigantic 6 million workers impacted by the informal economy (Phnom Penh Post, 2021). The large size of the informal economy prevented the creation of a more comprehensive safety net and an accurate assessment of the losses incurred in revenue and employment.

COVID-19 highlighted the structural limitations of the economic model that had fueled Cambodian growth for two decades, whether its narrow base, limited pool of international partners, or the large size of its informal economy. The Cambodian Government had been aware of these weaknesses. While COVID-19 catalyzed accelerated reforms, an overall structural transformation of the economy had already been engineered through a series of policies and actions.

5. ACCELERATING STRUCTURAL TRANSFORMATION

5.1 The Necessity for Structural Transformation

The Royal Government of Cambodia identified the challenges to sustaining high growth relatively early towards reaching the upper middle-income status by 2030. The country needs to move beyond its cheap-labor intensive model towards a more diversified economy that creates higher value added. It needs to balance sectors' contribution to growth, especially by improving agriculture; it needs to strengthen the SME landscape, improve its standards, plug it into foreign direct investment, and connect it to export markets; finally, it needs to accelerate the formalization of its economy and improve guarantees given to investors in such fields as fair competition, transparent and efficient public services, and protection of intellectual property to name the most vital (EuroCham, 2019a) areas.

The Government and its multilateral partners, such as the World Bank, the IMF, and the ADB, agreed on the challenges to be addressed, and corresponding objectives

have been stated in defining government policies. In 2018, Phase IV of the Rectangular Strategy, the cornerstone of the Government's political platform, "emphasized the need to seek new growth sources to ensure high and sustainable economic growth by taking full advantage of the regional opportunities, creating value added in the existing economic pillars and their related sub-sectors, encouraging investment in agriculture, ensuring readiness to grab new technologies in the era of digital economy as well as to grab opportunities and to overcome potential challenges in the context of industrial revolution 4.0, and enhancing Cambodia's competitiveness in response to new concerns and demand from the people in new development phase and our goal of becoming an upper middle-income country by 2030 and a high-income country by 2050."⁹

In 2015, the Royal Government launched its flagship Industrial Development Policy (IDP) that aimed to "maintain sustainable and inclusive high economic growth through economic diversification, strengthening competitiveness and promoting productivity." The Government announced the formulation of the IDP in Phase III of the Rectangular Strategy adopted in 2013 to move the country "to a higher value chain in the regional and global economy, especially within the rapidly growing Asian market, while paying attention to upgrading skills and vocational training for Cambodian workers." The IDP is indeed based on two critical approaches: (1) expansion of the industrial base supported by increased attractiveness of Cambodia to investors and investment promotion, including modernization of SMEs, and (2) improved connectivity with regional production networks to integrate with and move up the global value chains." On the tourism side, vocational training, market diversification, attempts to tap into the gigantic Chinese reservoir of travelers (Phnom Penh Post, 2017), and campaigns to promote a higher supply of domestic goods and services have also been undertaken, with more or less success.

In addition, other reforms have been carried out to strengthen, support, or complete the realization of the above-described objectives. The most overarching one is the 2019-2023 National Strategic Development Plan, which includes references to industrial diversification, value-added, and promotion of the agricultural sector. More specific tools include the SME Policy, the Master Plan on Intermodal Transport Connectivity and Logistics System, the Digital Economy Framework, the Science, Technology, and Innovation Road Map 2030, and the National Employment Policy 2015-2020.

5.2 Slow Changes

The implementation and impact of the IDP have been monitored by the CDC, which is in charge of its overall coordination. The word coordination matters here because while the CDC is indeed the one-stop window for foreign investment, the

authorizations it delivers have to be implemented by other institutions such as the General Department of Taxation, the General Department of Customs and Excise, and other bodies that are not under the authority of the CDC. As the need for proper coordination among ministries in Cambodia is one of the significant obstacles to the ease of doing business, this is an essential point to stress.

The IDP indicators monitored by the CDC show that structural transformation is slowly happening, although not always at the pace expected. Industrial diversification has been taking place, with the share of non-garment manufactured exports growing from 5.6 percent in 2015 to 15.5 percent in 2020. Results on the agriculture side remain below expectations, with the share of processed agricultural goods declining from 5.8 percent to 4.9 percent of exports, even though it has increased in value in the same period (CDC, 2021). Overall, garment exports no longer account for most of Cambodia's goods exports as of April 2021 (World Bank, 2021b).

Besides a surge in bicycle exports, Cambodia became ASEAN's largest supplier of bicycles to the European Union in 2017 (ScandAsia, 2021), and the production of electrical and vehicle parts has also been increasing. This type of diversification is mainly ensured by Japanese foreign direct investors (Phnom Penh Post, 2022), who build workers' skills through dedicated training programs that increase productivity.¹⁰ This component is incentivized through the new Law on Investment adopted in 2021. Companies like Sumi Cambodia (wiring systems), Denso (automotive and motorcycle parts), and especially Minebea (precision electronic components) have opened factories in Cambodia over the past decade. In late 2021, the General Manager of one of the largest Special Economic Zones shared with the author that his Japanese tenants had reported constant productivity increases following personnel training. Other investors, such as RMA, Daehan, and others, are setting up vehicle assembly factories in the Kingdom. The same General Manager who had noted the absence of domestic backward linkages in 2018 reported in 2021 that such linkages are now finally taking place in the form of a few foreign investors opening factories in Cambodia to supply inputs to other export-oriented foreign investors.

5.3 Policies Continue Unfolded

The new Law on Investment, adopted in late 2021, is the most recent initiative to foster this necessary structural transformation of the economy. This law has a much broader scope than its previous versions, expanding the list of incentivized sectors (EuroCham, 2021) to include tourism, education, vocational training, SME clusters, and the digital industry, among many others. It also introduces tax incentives for research and development, skills training, and corporate social responsibility to enhance competitiveness, diversification, productivity, and technology transfers.

The Government is also taking steps to address investors' concerns regarding unfair competition, such as enacting the 2021 Competition Law and adopting a Consumer Protection Law in 2019.

The Government has intensified its support for SMEs. In 2020, the Ministry of Economy and Finance launched the SME Bank to address the long-decried limited access to finance facing local SMEs. Offering “better access to financing” at a “cheaper cost,” the SME Bank also provides advisory services to its clients to improve productivity and succeed in securing export markets. Earlier in 2019, the Ministry of Economy and Finance established Khmer Enterprise - a specialized institution tasked with providing financial and non-financial support to “entrepreneurs, innovative startups, potential SMEs and partner institutions who participate in promoting entrepreneurial activities driving innovation and value-added creation in Cambodia’s economy.” The future will ascertain whether these two innovative bodies and similar initiatives will make a difference and contribute to upgrading the Cambodian SME landscape.

Another essential tool launched before COVID-19 is the digitization of public services. As early as 2015, the Ministry of Commerce initiated an online business registration system, which was soon followed by more initiatives in other government services. The ultimate objective was to create a single window and database for business, tax, and labor registration. Admittedly, the aim is not only to improve efficiency and shorten delays but also to limit human interaction and reduce the risk of non-transparent practices.

At the same time, the public and private sectors are striving to promote the digitization of SMEs, a trend that will help to overcome inefficiency issues. Since 2015, the Ministry of Posts and Telecommunication has partnered with the then Ministry of Industry and Handicraft to encourage tech startups and Micro, Small and Medium Enterprises (MSME) digitization (EuroCham, 2018b) before launching the “Digital Cambodia” fair in 2019 and transforming the former National Institute of Posts, Telecommunications, Information and Communication Technology (NIPTICT) into a newly revamped Cambodia Academy of Digital Technology (CADT). Further capitalizing on these initiatives, a “Digital Economy and Social Policy Framework of Cambodia 2021-2035” was adopted in early 2020, and the Ministry of Industry and Handicraft was revamped into a Ministry of Industry, Science, Technology, and Innovation. Recognizing the importance and broader scope of the digital economy, an E-Commerce Law was also adopted in 2021.

With Cambodia having successfully tamed COVID-19 through high vaccination rates and other targeted measures, the country could reopen fully before other central destinations in Southeast Asia (particularly Thailand, of which Cambodia had long been a satellite destination). Tourism professionals hailed this achievement as a

unique opportunity for Cambodia to position itself as a full-fledged destination instead of a next-stop destination.¹¹

On the foreign trade front, Cambodia's ratification of new free trade agreements is opening the way toward further integration into regional and global value chains with a better repatriation of the Kingdom's foreign partners. The free trade agreements signed with China on the one hand and with South Korea on the other hand, which entered into force in 2022, lifted tariffs on more than 90 percent of products originating from each country and provided opportunities for more foreign direct investment. Mainly, there is hope that these free trade agreements will contribute to finally unlocking the long-dormant potential of Cambodia's agriculture sector by moving from the already increasing fresh fruit exports. The protocols on phytosanitary requirements have already been signed between China and Cambodia for fresh mangoes and bananas (Xinhuanet, 2020) for processed product exports. Thanks to foreign direct investment, processing capacities will be developed to meet the export markets' standard requirements (DFDL, 2021). Even more importantly, the 15-member Regional Comprehensive Economic Partnership brings considerable opportunities for Cambodia's deeper integration into Asian value chains due to favorable rules of origin in what will be the largest free trade area in the world. Therefore, these three free trade agreements can contribute to balancing Cambodia's dependence on Western markets – although they may also deepen Cambodia's dependence on the Chinese economy. Finally, Cambodia's insertion into the Chinese Belt and Road Initiative contributes to the Government's strategy of capitalizing on the Kingdom's central position in ASEAN through physical infrastructure development.

With the recession highlighting Cambodia's structural weaknesses, the Royal Government integrated its existing policies into a "Framework for Post-COVID-19 Economic Recovery Plan 2021-2023" designed by the Ministry of Economy and Finance. As part of this Recovery Plan and its three-pronged approach ("Recovery – Reform – Resilience"), three areas were identified for short-term action: SMEs, agriculture, and tourism. Further, two sectors were identified for potential short to medium-term action: digital trade and assembly industry (RGC, 2021).

5.4 Priorities for a Structural Transformation

Figure 4.5 summarizes the mechanism transforming Cambodia into a more diversified, efficient, and inclusive economy. The current structure represents the Cambodian economy as a pyramid. On top of that pyramid is a dynamic, foreign investment-driven, export-oriented layer comprising manufacturing and tourism industries. This layer has driven Cambodia's past growth in association with construction and real estate. However, it must diversify its production and markets to grow and add value.

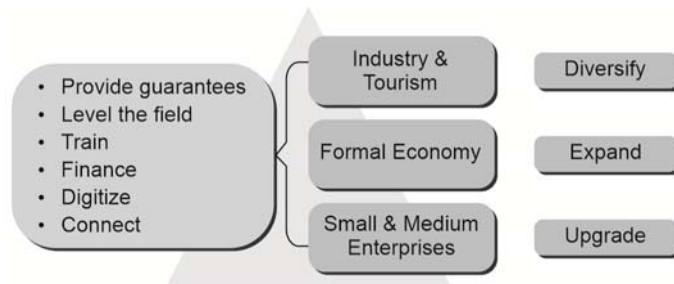


Figure 4.5: Cambodia's Road to Structural Transformation

The second layer is the formal economy. It comprises all businesses beyond the first layer that fulfill a minimum set of requirements in terms of business, tax, and labor registration and, therefore, contribute to the economic growth accounted for by the national accounts. This formal economy needs to expand as fast as possible to further Cambodia's transformation into a modern economy that generates, collects, and redistributes enough wealth to rely on itself and not only foreign donors' support. This layer also needs support to constantly uplift its standards in terms of governance, quality, and innovation so that it can partner with the first layer and create backward linkages for the manufacturing industry, reduce leakages in the tourism industry, and conquer export markets for its products and services, or cater to the ever-growing demands of the emerging Cambodian middle-class.

At the bottom is the third layer: a large, informal, inefficient SME landscape representing numerous businesses and employees providing sub-standard products and services to the domestic market. This bottom layer needs upgradation to become part of the formal economy and join the second layer. It must be formalized and contribute to the national accounts. This layer is the largest but least efficient layer and generates the smallest value added. Its workers and employees are also the most vulnerable in times of crisis.

The policies strengthening Cambodia's competitiveness and attractiveness are the tools to diversify the top layer, expand the middle layer, and upgrade the bottom layer. These policies include providing guarantees to investors, leveling the playing field, training the workforce, ensuring access to finance, expanding domestic and international physical connectivity, and accelerating the digitization of the economy and public services.

6. CONCLUDING REMARKS

The past three decades have seen Cambodia's economy undergo extraordinary changes as it transitioned from socialism to a free market, experienced unplanned and massive dollarization, and finally turned itself into a foreign investment-driven, export-oriented producer of goods and services.

As COVID-19 generated an unprecedented external shock on Cambodia's economy, the crisis catalyzed the acceleration of Cambodia's structural transformation towards a more diversified, skills-based economy capable of generating more value added.

The multiple reforms and policies engaged by the Royal Government target vital areas to achieve Cambodia's aim of attaining an upper-middle income status by 2030. However, success in their implementation will depend on how the Government productively addresses cross-cutting challenges.

One of the most critical challenges is the need for inter-ministerial coordination. As Cambodia's economy becomes increasingly sophisticated, coordination is necessary to improve the ease of doing business in the Kingdom. Too often, what looks like an easy road map is hindered by an absence of communication and mutual understanding between different ministries, resulting in frustration and even failure for investors.

As far as public service is concerned, digitization will only bear fruits if it is ultimately achieved. As the General Manager of the Special Economic Zone (SEZ) stated, "real digitization means no paper, no human, and only electronic signature." Digitization can improve the ease of doing business in Cambodia if it is comprehensively implemented. Again, this will demand coordination among ministries as the ultimate objective is consolidating the database of commerce, tax, and labor registrations.

This challenge is connected to the fair implementation of all regulations, a decisive factor in attracting and fostering quality investment, whether domestic or foreign. A level playing field with clear rules will attract responsible investors ready to compete fairly. On the contrary, an uneven playing field, whether because some are favored instead of others or because rules are ill-interpreted and ill-implemented, will attract the type of investment that thrives on non-compliant practices.

On the private sector side, the next big challenge is related to the overall quality of Cambodia's products and services. While many steps have been made to improve standards in all fields (education, management, bookkeeping, products, services, and others), quality cannot be decided by decree. The efficient implementation of institutions requires building necessary capacities, such as the transformation of the Ministry of Industry and Handicrafts into the Ministry of Industry, Science, Technology, and Innovation, the strengthening of the Institute of Standards and other similar institutions, the adoption of specific regulations related to product quality (included for imported products such vehicles or food and beverage). Standards are not only about equipment but, above all, about human skills; setting up a regulatory framework without enough human competencies may lead to counterproductive results in implementation, including safety risks for the consumer

and the usual ordeal of unfair competition if both the inspector and the vendor do not understand the standards that are required by the law. This challenge highlights the absolute necessity of furthering all efforts carried out in the fields of education and vocational training.

Beyond Cambodia's control, the international conjuncture may help or slow down ongoing progress. The US-China tensions, the current conflict in Ukraine, and other crises, such as the situation in Myanmar, are variables over which Cambodia has no control but that may bring unexpected consequences to the country. Their impact can be positive or negative, with the realignment of FDI flows, inflationary shocks, renewed Cold War pressure, and more.

Ultimately, both the public and the private sectors will have to build the conditions that warrant a successful structural transformation, sometimes individually, often hand in hand. Succeeding in this endeavor will enable Cambodia to resume steady growth in an ever-changing international context and achieve its goal of becoming an upper-middle income economy by 2030.

ENDNOTES

1. Figures from the World Bank. <https://data.worldbank.org/>
2. The Garment Manufacturers Association in Cambodia (GMAC) communication.
3. See contents of the EuroCham 2019 Real Estate and Construction Forum panel on Investment Opportunities, where a Chinese speaker explained the business model of real estate projects designed by Chinese developers to be marketed to Chinese audiences living in China, on the prospect of reselling them with a margin on the medium-long term.
4. Communication by the General Manager of a leading construction project management company.
5. This was an observation shared during the EuroCham Logistics Forum's panel on Investment Readiness in 2018, which the author moderated.
6. Discussion with a seasoned tourism industry professional, 2019.
7. The author communicates personally with industry leaders and is supplemented by direct observation during the COVID-19 crisis.
8. While export growth towards the European Union became negative, it only slowed towards the USA.
9. 'Cambodia's medium-term outlook and policies to enhance competitiveness' – talk by His Excellency Sok Chenda Sophea, former minister attached to the Prime Minister and Secretary General of the Council for the Development of Cambodia, at the Center for Strategic and International Studies virtual public webinar on "The future of work in the Mekong subregion."
10. The author communicates personally with representatives of the Japanese business community.
11. The author communicates personally with tourism professionals focused on Western markets.

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