

CAMBODIA ECONOMIC UPDATE



RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

SPECIAL FOCUS

Upgrading Cambodia in Global Value Chains

NOVEMBER 2019



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Recent economic developments and outlook



WORLD BANK GROUP

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ABBREVIATIONS

AFTA	ASEAN Free Trade Agreement
ASEAN	Association of Southeast Asian Nations
Brexit	Withdrawal of the United Kingdom from the European Union
CEU	Cambodia Economic Update
CR	Cambodian riel
DSA	debt sustainability analysis
EAP	East Asia and Pacific
EBA	Everything But Arms
EC	European Commission
EMDEs	emerging markets and developing economies
EU	European Union
FCD	foreign currency deposit
GDP	gross domestic product
GVC	global value chain
HCI	Human Capital Index
IMF	International Monetary Fund
ILO	International Labor Organization
LPCO	Liquidity-Providing Collateralized Operation
MFA	multifiber agreement
NCD	negotiable certificate of deposit
NPL	nonperforming loan
OECD	Organisation for Economic Co-operation and Development
PISA	program for international student assessment
PPP	Public-private partnership
RMS	Revenue Mobilization Strategy
SDR	Special Drawing Rights
SME	small and medium-sized enterprise
UK	United Kingdom
UN	United Nations
US	United States
US\$	United States dollar
VAT	value-added tax
WBG	World Bank Group
WDI	World Development Indicator
y/y or yoy	year-on-year

EXECUTIVE SUMMARY

Recent developments

Cambodia's economy continues to show signs of robust growth, underpinned by solid export performance and strong domestic demand. Key macroeconomic data for the first six-months, however, indicate a slight deceleration of economic activity this year, compared to a strong growth performance of 7.5 percent in 2018. Garment and footwear exports, accounting for about 70 percent of total merchandise exports, grew at 17.7 percent in 2018, but eased slightly to 15.3 percent (y/y) in June 2019.

Bustling construction activity has continued, reflecting a sustained appetite for investment. As a result, steel imports skyrocketed, rising 63.5 percent (y/y) in volume terms in June 2019, up from 27.7 percent in 2018. During the first half of 2019, although the reported value of newly approved investment projects accelerated, foreign direct investment (FDI) inflows, of which about 40 percent originated from China, eased. The tourism sector remained resilient; international arrival growth increased to 11.2 percent (y/y) in June 2019, compared with 10.7 percent in 2018, with almost 40 percent of foreign visitors coming from China.

Rising domestic consumption fueled by a surge in FDI inflows in recent years drove import growth. Imports of petroleum products and motor vehicles rose by 91.0 percent and 18.5 percent, respectively. Thanks mainly to depressed domestic food and oil prices, inflation continued to be subdued, declining slightly to 1.4 percent (y/y) in mid-2019, down from 1.6 percent in 2018. While being softly pegged at around 4,000 riel per US dollar, the local currency depreciated slightly to 4,089 riel per US dollar in August 2019, up from 4,018 riel per US dollar in December 2018, likely due to slower capital inflows.

Growth in labor income was the key driver of poverty reduction in Cambodia. Income decompositions show that wage and non-

wage agriculture income were the main drivers of poverty reduction in Cambodia during the period 2009-17. In urban areas, declining non-labor income increased poverty between 2009 and 2013, before rising and helping to reduce poverty during 2013-17. Non-labor incomes were rising throughout the rural areas, contributing to poverty reduction in both subperiods. Remittance, a subcomponent of non-labor income, continued to reduce poverty rates in both urban and rural areas. The share of remittances to total household income increased from 3 percent in 2009 to 12 percent in 2017 – among the poorest households. The contribution of transfer to poverty reduction was very small, reflecting the weak public social protection programs.

The financial sector is playing an increasingly important role in the economy. Bank credit growth accelerated to 28.3 percent (y/y) by mid-2019, up from 24.2 percent in December 2018. Reflecting the tapering of capital inflows, growth in foreign currency deposits slowed down to 21.7 percent (y/y) by mid-2019, compared with 25.8 percent in December 2018. However, accumulation of gross international reserves accelerated, partly underpinned by initial success in expansion of the use of local currency. Gross international reserves reached US\$11.3 billion (more than five months of import coverage) or 24.7 percent (y/y) in mid-2019, up from US\$10.1 billion or 15.8 percent (y/y) at the end of 2018.

Fiscal performance continued to be characterized by impressive revenue performance, due largely to continued improvements in customs and tax administration and bustling economic activity. Total revenue (including grants) reached 23.6 percent of GDP in 2018 and is projected to remain sustained at the same level in 2019. Despite continued pressures from a rising public wage bill, government outlays are expected to remain contained at 24.2 percent of GDP in 2019. As a result, the overall fiscal deficit is anticipated to remain almost unchanged

at 0.6 percent of GDP in 2019, thanks to continued strong revenue performance.

Outlook

Cambodia's exports are expected to moderate with the easing of global demand, while investment decelerates with sluggish capital inflows due to slower projected growth in China. The economy is therefore projected to ease gradually in the short to medium term. Growth is expected to decelerate to 7.0 percent in 2019, down from 7.5 percent in 2018. The easing of exports and continued strong growth in imports will result in a widening of the country's current account deficit to 9.8 percent of GDP in 2019, up from 9.4 percent of GDP in 2018, but remain fully financed by foreign direct investment.

A relatively large fiscal stimulus to be financed by government savings could be introduced in 2020 to mitigate the negative impacts of the potential withdrawal of Everything But Arms (EBA). In February 2019, the European Union (EU) launched the process that could lead to the temporary withdrawal of Cambodia's preferential access to the EU market through the EBA initiative in 2020.

Poverty reduction is expected to continue. Economic growth, particularly growth in labor income in the form of higher wage income, continues. Labor income has now become the main driver of poverty reduction. However, most of the poor have wage incomes and low-paying jobs, signaling that low skills and productivity remain to be challenges. Inequality is on the rise in both urban and rural areas, with the largest increase in the rural areas.

Risks and challenges

Downside risks, arising from domestic and external factors, have intensified.¹ A possible withdrawal of the EBA initiative, as well as a sharp slowdown in the Chinese economy (a potential outcome of continued U.S.-China trade tensions), could substantially dampen growth prospects, given Cambodia's reliance on exports

to the EU and on the flow of FDI and tourists from China. Recently, high-frequency indicators have suggested a further moderation in economic activity in China. In addition, a prolonged construction and property boom and the increase of credit provided to the construction and real estate sectors alongside rising indebtedness—where combined bank and microfinance credit now accounts for over 100 percent of GDP—also present a downside risk for Cambodia.

The National Bank of Cambodia's latest financial stability review² discussed potential macroprudential policies both on the supply and demand sides, while emphasizing the importance of effective interagency coordination. For a supply-side macroprudential policy, an example of a widely used tool in other countries is a sectoral capital requirement measure, where higher risk weights could be imposed on loans to construction and real estate-related sectors. To mitigate potential risks of speculation and to safeguard sound lending practices, demand-side macroprudential measures have been under consideration. Equally important, fiscal policy could be used to deal with potential vulnerabilities in the real estate sector. For instance, last year, Singapore introduced property cooling measures by raising the rates of the Buyer's Stamp Duty currently levied on all purchases of properties, except on its citizens and permanent residents who are purchasing their first home.

Cambodia's remarkable participation in global value chains (GVCs) began in the 1990s following the arrival of the export-oriented garment and footwear industry. GVC participation grew faster in Cambodia than in other regional countries such as Malaysia, Thailand and Vietnam as well as other developing countries such as Bangladesh and Sri Lanka, although from a low base. The recent years however are marked by stagnation. Unlike other countries in the region, Cambodia has not been able to transition to the next stage of GVC participation of advanced manufacturing and services. Instead, there has been little diversification into other value chains, but also little upgrading within existing value chains.

¹ EBA withdrawal (and fiscal stimulus) is not factored in.

² https://www.nbc.org.kh/download_files/publication/fsr_eng/FSR-for-publication-final-22Apr2019.pdf

FDI inflows, a large pool of low-skill and low-wage labor, and preferential access to key exports markets are behind Cambodia's rapid integration into limited manufacturing GVCs.

Global experience shows that transitioning to limited manufacturing GVCs from primary product specialization typically requires FDI, competitive labor costs, addressing business climate constraints, assuring basic political stability and rule of law, and timely access to imported inputs. Advanced manufacturing GVCs typically require a more educated workforce and improvements in managerial practices and technical skills. Improved access to finance for domestic firms, more advanced logistics, competitive energy costs, access to more sophisticated services inputs, and enhanced contract enforcement are needed for these advanced manufacturing and services sectors. Policy predictability, in addition to macroeconomic stability, becomes an increasingly important dimension of governance. Improving the country's external competitiveness through increased productivity in the presence of rising wages is therefore imperative. Cambodia's ranking in the ease of doing business index continued to slip, declining to 144th in 2019, down from 127th in 2016, when the country's ranking improved, compared with its 135th ranking in 2015. The authorities recently introduced measures to

facilitate trade by lowering logistics costs and supporting businesses with a six-day reduction in the number of publicly observed holidays in 2020.

Human capital accumulation is vital for countries' integration in more complex GVCs.

Countries that are human-capital abundant tends to export products that are more human-capital intensive. Cambodia's export basket not only contains products that employ fewer skilled workers than the products exported by comparator countries, but Cambodia has also seen less progression towards more skill intensive products over the past decade than comparator countries.

To move to the next stage of participation, a much more sophisticated policy mix is needed.

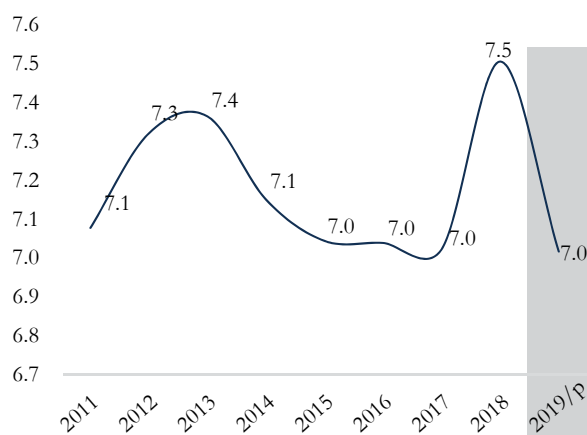
First, expand and deepen trade agreements to go beyond issues of market access and national treatment. Second, lower barriers to trade and connect to markets to expand Cambodia's small domestic market size and gain access to the inputs needed for production. Third, continue improving the education and skills of Cambodia's labor force. Fourth, harness the digital economy to support firms to integrate into GVCs through digital platforms as well as connect value chain participants.



CAMBODIA'S RECENT DEVELOPMENTS AT A GLANCE

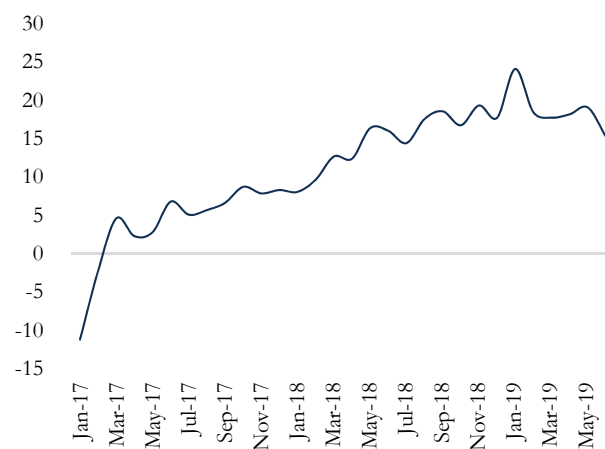
Real growth is projected to decelerate...

Real growth (percent)

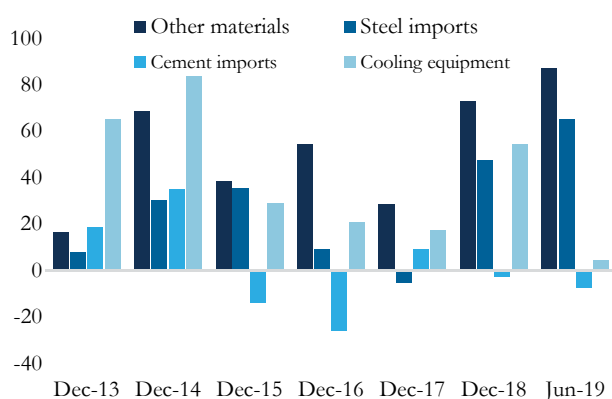


... as key exports eased...

Garment and footwear exports (y/y, percent change)

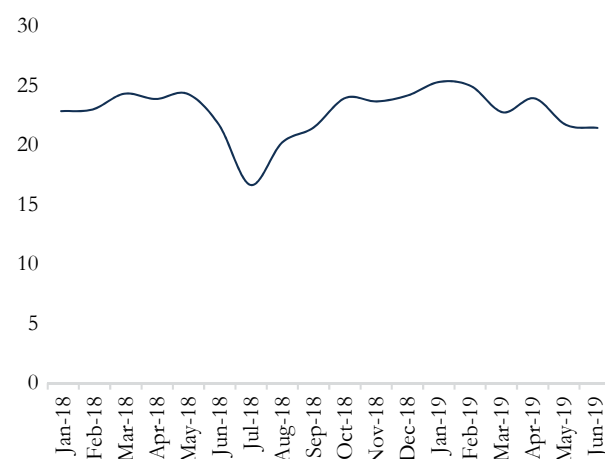


... construction sector expansion, however continued... Construction materials and steel imports (y/y, percent change)



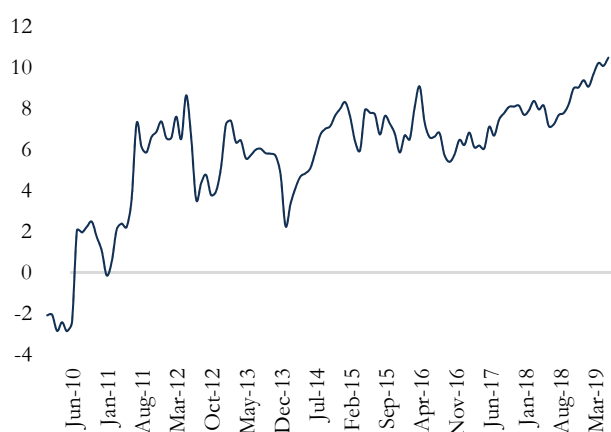
...underpinned by accommodative broad money

Broad money (y/y, percent change)



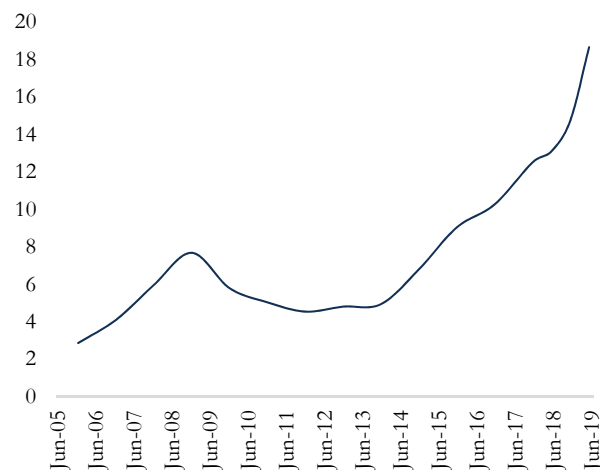
...with increased lending to the construction sector

Contribution to credit growth of lending to the construction and real estate sector (percentage points)



Government deposit (savings) increased further

Government deposit at the banking system (percent of GDP)



Sources: Cambodian authorities and World Bank staff estimates and projections.

Note: p = projection.

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西港特区工业园

Industrial Park of Sihanoukville Special Economic Zone



Section I

Recent Economic Developments and Outlook



Recent Economic Developments and Outlook

Recent developments

While slightly easing, growth remains robust

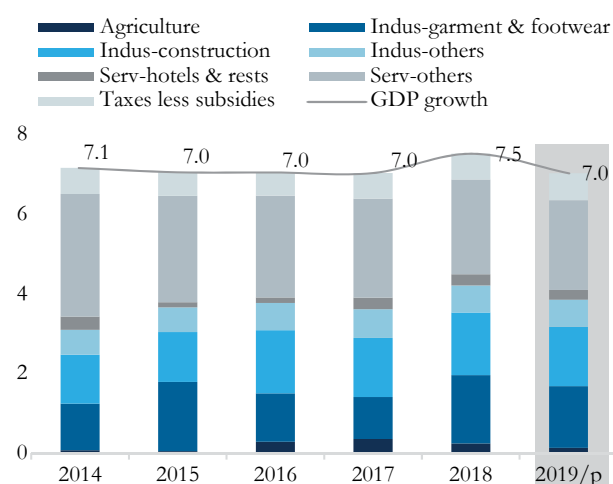
Growth continues to remain robust in 2019, underpinned by strong performance in the garment, construction and tourism sectors. Key macroeconomic data for the first six months, however, indicate a slight deceleration of economic activity this year, compared with a better-than-expected growth performance of 7.5 percent in 2018 (figure 1). While economic growth is projected to ease to 7.0 percent in 2019, Cambodia is likely to remain the fastest-growing economy in the developing East Asia and Pacific (EAP) region.

Growth in developing EAP slowed in the first half of 2019.³ Regional growth declined from 6.5 percent year-on-year (y/y) in the first half of 2018 compared to 6.0 percent y/y in the first half of 2019, reflecting a broad-based deceleration (see box 1). Intensifying trade disputes with the United States weighed down on China's economic growth, which continues to soften amid a planned rebalancing of the economy towards a consumption-led growth. China's economic growth slowed in the first half of 2019, and

a sharp deceleration of industrial activity has been observed in July. Growth moderated to 6.3 percent year-on-year in the first half of 2019 from 6.8 percent in the first half of 2018, reflecting weaker exports and private investment growth. Most other major regional economies experienced growth slowdowns. Activity in the smaller regional economies, however, remained robust.

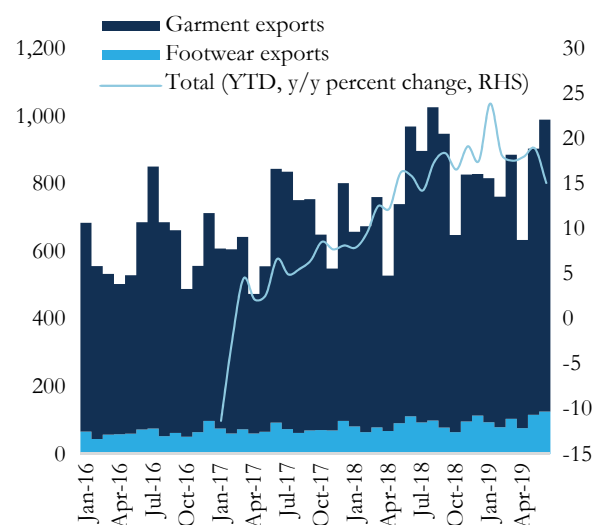
There was a slight deceleration of Cambodia's garment and footwear exports, which grew at 15.3 percent in June 2019, compared with 2018's 17.7 percent y/y uptick (figure 2). Disaggregating the export data shows that while garment exports slightly eased to 14.7 percent y/y, down from 17.6 percent in 2018, footwear exports accelerated, reaching 20.0 percent y/y in June 2019, compared to 19.2 percent in 2018. As a result, the share of footwear products in the total garment and footwear exports rose gradually to 12.0 percent in June 2019, compared to only 11 percent in 2018 and 10.8 percent in 2017. The deceleration was the result of slow external demand. In the first of half of 2019, US retail sales, gauging US domestic demand, eased. The retail trade (excluding automobiles) monthly sales for companies in the retail trade and food services sectors, decelerated

Figure 1: Contribution to real growth
(percent)



Source: Cambodian authorities.
Note: p = projection.

Figure 2: Garment and footwear exports
(US\$ million)



Source: Cambodian authorities.
Note: RHS = Right-hand scale.

³ World Bank 2019d.

Box 1.

Global and Regional Outlook and Risks¹

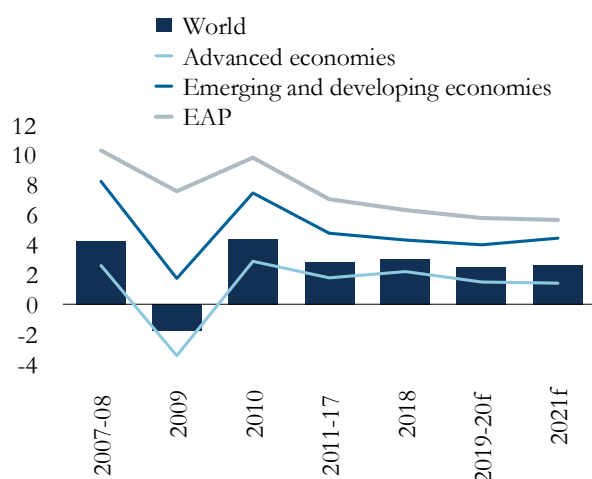
Global growth is expected to remain subdued over the forecast horizon. The global economic growth rate is projected to slow to 2.5 percent in 2019, reflecting a broad-based weakness in advanced economies and major emerging market and developing economies (EMDEs). Global growth is projected to remain flat in 2020 before strengthening insignificantly to 2.6 percent in 2021 (figure B1.1). Growth in advanced economies is projected to moderate from 2.2 percent in 2018 to 1.5 percent on average during 2019–21, reflecting a sharp deceleration in trade, investment, and manufacturing. Growth in EMDEs is projected to slow to 3.7 percent in 2019 before recovering to 4.2 percent in 2020 as earlier headwinds in some countries ease. This forecast is predicated on the waning impact of earlier financial pressures currently weighing on activity in some large EMDEs and no major deterioration in the global environment (for example, Argentina, Brazil, Russia, and Turkey) and no major deterioration in the global environment.²

Global economic conditions are expected to remain challenging over the forecast period. The increase in tariffs by China and the United States that were announced over during 2019 will have more severe effects than the tariff hikes implemented in 2018. Beyond economic losses for the affected exporters, the re-escalation of trade tensions

is contributing to heightened policy uncertainty, which is expected to dent confidence and investment. Barring a renewed escalation of trade tensions, global trade growth is projected to weaken from 4.1 percent in 2018 to 1.9 percent in 2019, and then recover modestly to 2.2 percent in 2020. (figure B1.2). This forecast is predicated on policy support measures implemented in major economies and firmer domestic demand in some EMDEs. This modest rebound notwithstanding, global trade is expected to be weaker than previously envisaged over the forecast horizon, reflecting a softer outlook for global investment and evidence of a lower income elasticity of trade.

Global financing conditions are expected to remain volatile, even if generally more supportive. This reflects more accommodative monetary policy stances adopted by the major central banks in the near term due to the deteriorating global growth prospects. Despite the recent recovery of EMDE markets from the 2018 correction episode, there is still a considerable risk of “monetary shocks” associated with the global policy uncertainty. Financial market volatility will continue to have the strongest impact on countries with high vulnerabilities, weak growth prospects, and elevated policy uncertainty. The eventual rise of advanced-economy yields will have a negative impact on capital flows to EMDEs. Policy

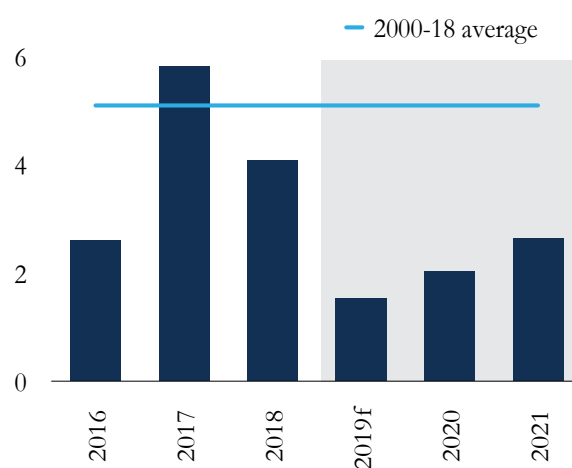
Figure B1.1: Real GDP growth (percent)



Source: World Bank.

Notes: Working assumptions. Updated global projections will be published in Global Economic Prospects, January 2020 (forthcoming).

Figure B1.2: Global trade volume growth (percent)



Source: World Bank.

Notes: Working assumptions. Updated global projections will be published in Global Economic Prospects, January 2020 (forthcoming).

¹ This box was prepared by Ekaterine Vashakmadze, PG.

² These are working assumptions, which will be finalized and published in the June 2019 Global Economic Prospects, World Bank.

uncertainty, geopolitical risks, and security concerns could also continue to adversely impact EMDE capital inflows.

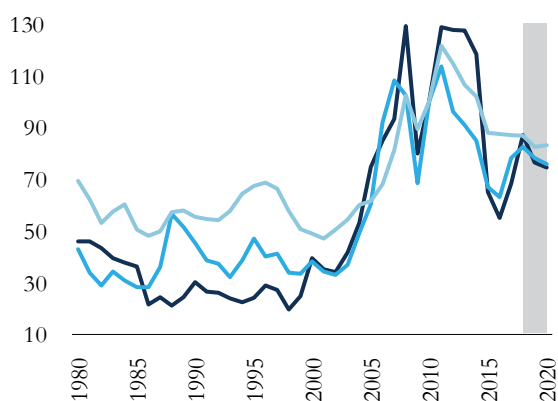
Modest declines are forecast for global commodity prices. Oil prices are expected to average US\$60 per barrel in 2019 and 2020, with high uncertainty around the outlook. Overall, metals prices are expected to decline slightly in 2019 and 2020, reflecting a weaker outlook for global metals demand. Agricultural prices are expected to remain broadly flat in 2020 (figure B1.3).

Growth in the region is projected to slow from 6.3 percent in 2018 to 5.8 percent on average in 2019-20, and to ease further to 5.6 percent by 2021. This outlook assumes no further escalation of trade tensions between China and the United States, slightly lower commodity prices, and supportive global financing conditions, especially in the near term. The baseline also assumes that the fiscal and monetary policy support in China and the other major regional economies would partly mitigate the impact of heightened policy uncertainty and weak global demand on the regional growth. Growth in China is projected to slow to 6.1 percent in 2019 and ease further to 5.9 percent in 2020 and 5.8 percent in 2021 amid continued domestic and external headwinds (figure B1.4). Growth in the rest of the region is projected to decline to 4.9 percent in 2019 and stabilize at 5 percent on average in 2020-21. While growth

in the region is projected to remain robust in the near term, underlying potential growth—which has fallen considerably over the past decade, in large part reflecting slowing potential growth in China—is likely to decline further over the long term, largely owing to deteriorating demographic trends, especially in China, Thailand, and Vietnam.

Risks continue to be firmly on the downside. There is considerable uncertainty around the outlook for the global economy. The balance of risks remains firmly on the downside and has recently intensified, reflecting the re-escalation of trade tensions amid heightened global uncertainty. Although unlikely in the near term, the simultaneous occurrence of a sharper-than-expected slowdown in China, the Euro Area, and the United States could trigger a significant downturn in global activity. The further escalation of trade tensions could be highly disruptive to global activity amid the presence of complex value chains. The risk of severe and broad-based financial stress adversely affecting the outlook for EMDEs remains high amid elevated debt levels in many countries. Policy uncertainty and geopolitical risks remain high, and could negatively impact confidence and investment in both affected countries and globally. Policy uncertainty is particularly elevated in a number of European countries, including the United Kingdom as it transitions out of the European Union.

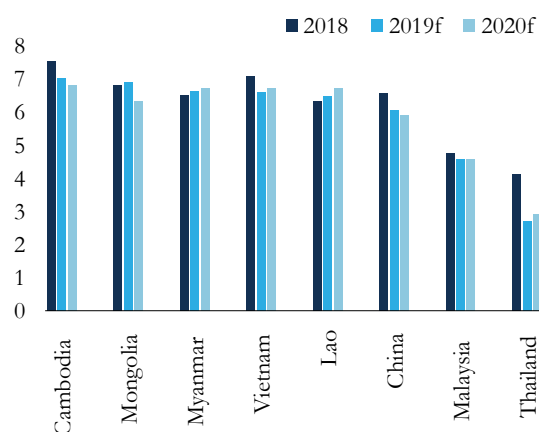
Figure B1.3: World commodity price forecast
(Index=nominal U.S. dollars, 2010=100)



Source: World Bank.

Notes: Working assumptions. Updated global projections will be published in Global Economic Prospects, January 2020 (forthcoming).

Figure B1.4: Regional growth
(percent)



Source: World Bank.

Notes: Working assumptions. Updated global projections will be published in Global Economic Prospects, January 2020 (forthcoming).

to 1.6 percent y/y in June 2019, compared to 5.9 percent in 2018 (figure 3).⁴

The share of Cambodia's exports to the US market is increasing

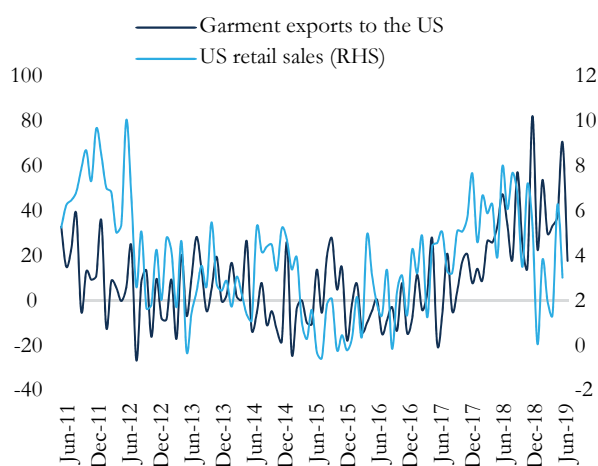
While the EU had been the most important market for Cambodia's garment and footwear exports during the past several years, the share of the US market has expanded rapidly since 2018, reaching 31 percent by June 2019, overtaking the EU market (excluding the UK), which shrunk to only 30 percent during the same period (figure 4). The recent expansion of the U.S. market share may have contributed in part by trade diversion resulting from the US-China trade war. As bilateral China-U.S. trade of tariff-affected products has declined,⁵ Chinese and U.S. imports of such products from other destinations have grown. Developing East Asian exporters also benefited: Vietnam and Malaysia feature among the top five beneficiaries in Chinese and U.S. markets, respectively, while Cambodia (from the United States) and Mongolia (from China) enjoyed relatively small gains in absolute terms but significant gains relative to their GDP. While remaining solid, Cambodia's garment and footwear exports to the U.S. market eased, expanding at 38.7 percent y/y in June 2019, down from 51.6 percent y/y in January. During the same period, the country's exports to the EU

market flattened, growing at 1.7 percent y/y in June 2019, down from 5.3 percent in January. The share of Cambodia's exports to the EU is expected to shrink further, if EBA suspension occurs next year. Boosted by the U.S. duty-free access granted on June 30, 2016,⁶ investment projects in the production of travel goods (luggage, backpacks, handbags, and wallets) has skyrocketed. Approved foreign direct investment projects in the travel goods sector rose to US\$202.5 million in the first eight months of 2019, up from US\$50 million in 2018. The total number of factories producing travel goods reached 105 factories in August 2019, up from 67 factories in 2018.⁷

While private investment rose, approved FDI eased

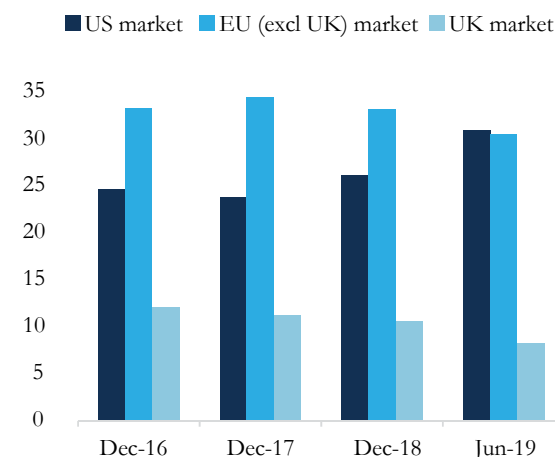
Foreign direct investment (FDI) commitments (approved FDI projects) has slowed in the first half of 2019, compared to 2018. During the first six months of 2019, the value of approved investment (domestic and FDI) projects increased to US\$4.6 billion or about a 60 percent y/y increase. During the same period, approved FDI inflows eased to US\$1.0 billion, compared with US\$2.4 billion in 2018. FDI commitments going to the agriculture and food processing (non-garment) industries, and wholesale and retail sectors eased.⁸ In the real sector, private investment continued to

Figure 3: U.S. retail sales and Cambodia's exports to the United States
(y/y, percent change)



Source: Cambodian authorities and United States Census Bureau.
Note: U.S. retail sales excluding auto and parts dealers.

Figure 4: Garment and footwear exports by main destination
(YTD, percent of total)



Source: Cambodian authorities.
Note: YTD = year-to-date.

⁴ Retail Trade, ex Auto: U.S. Total, Not Seasonally Adjusted Sales, US Census Bureau.

⁵ World Bank 2019d.

⁶ For more detail, see <https://kh.usembassy.gov/duty-free-access-travel-goods-made-cambodia/>

⁷ Monthly report (August 2019), Ministry of Industry and Handicraft.

⁸ Annual Report, 2018, the National Bank of Cambodia

flow to the construction, real estate, and tourism sectors, which together accounted for about three-quarters of total (approved) investment during the first six months of 2019. The construction boom has also fueled growing supporting industries, factors, and small and medium sized enterprises mostly owned by Chinese investors to manufacture and supply building material, furniture, metal, and plastic products.

Capital inflows have fueled rising domestic investment and consumption

A surge in capital inflows that Cambodia experienced in the past several years has underpinned domestic investment and consumption. Cambodia is among the most successful countries in attracting FDI with FDI inflows accounting for an average of 11.9 percent of GDP a year during the post-global financial crisis. With continued upbeat consumer and investor confidence, domestic demand has sustained and been met by a surge in imports. During the first six months of 2019, imports of petroleum products and motor vehicles rose by 91.0 percent and 18.5 percent, respectively (figure 5). To meet continued strong domestic demand, consumption goods imports such as foodstuff, electronics and medicines also increased, rising by 27 percent, 87.5 percent, and 14.7 percent, respectively. Similarly, bustling construction activity driven by upbeat investor confidence fueled construction materials

import growth. Imports of steel skyrocketed to 63.5 percent y/y in volume terms, up from 27.7 percent in 2018, while other construction materials rose by 87.1 percent y/y (figure 6).

The current account deficit widened, but remained fully financed by FDI

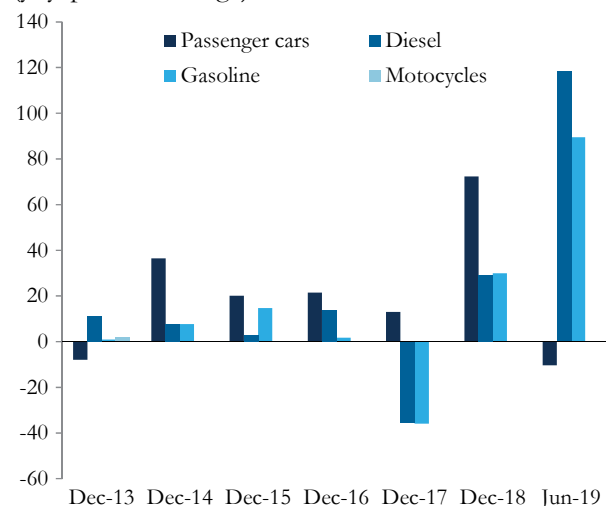
The easing of exports and continued strong growth in imports will result in a widening of the country's current account deficit to 9.8 percent of GDP in 2019, up from 9.4 percent of GDP in 2018, which remains fully financed by FDI. Although merchandise exports eased, net services exports rose, largely boosted by travel service receipts resulting mainly from tourism receipts. Current transfers were supported by workers' remittances (net), estimated to reach about US\$1.0 billion in 2018. Continued FDI inflows financed the current account deficit. FDI inflows and the injection of local currency allowed the central bank to continue to accumulate more international reserves, which reached US\$11.3 billion by June 2019, or 24.7 percent y/y, covering more than five months of prospective imports.

Vibrant construction activity continued, although FDI inflows eased

During the first six months of 2019, approved residential and commercial development projects amounted to US\$3.4 billion, or a whopping 56.5 percent y/y increase. In addition

Figure 5: Imports of durable goods and petroleum products accelerated

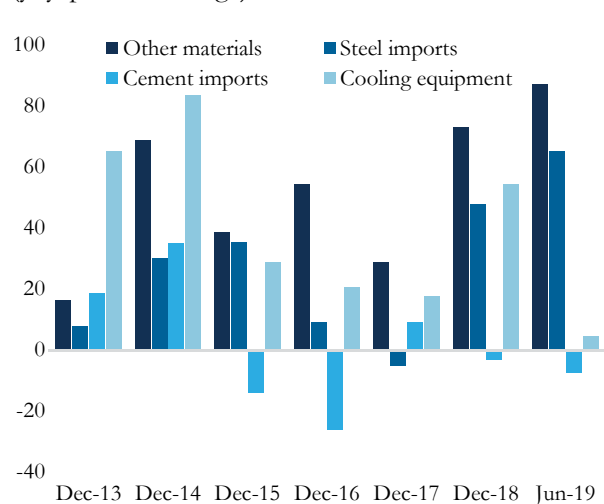
(y/y, percent change)



Source: Cambodian authorities.

Figure 6: Construction materials and steel imports skyrocketed

(y/y, percent change)



Source: Cambodian authorities.

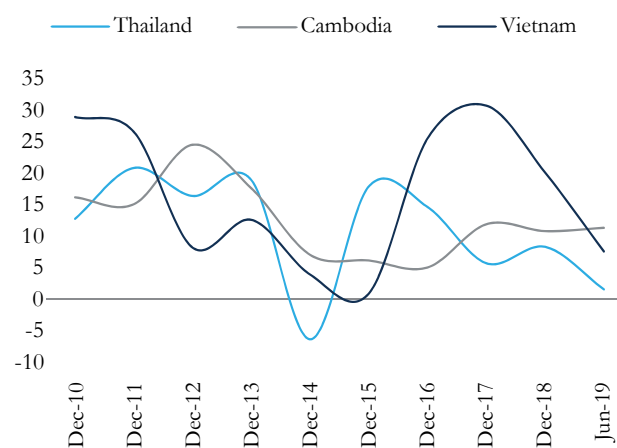
to the two largest cities of Phnom Penh and Siem Reap, international gateway cities such as the seaside town of Sihanoukville, the Cambodia-Vietnam and Cambodia-Thailand economic corridors of Bavet and Poi Pet have also been experiencing construction booms. The most rapid increase in construction activity has been in the provincial capital of Sihanoukville which received US\$1.0 billion of approved construction projects during the first six months of 2019, compared to US\$1.08 billion in investment for the entire 2018. As a result, Sihanoukville is being transformed into an industrial boomtown with bustling investment, trade and tourism activity, supported by a nearby international airport and the country's largest seaport. An expressway linking it to the capital city of Phnom Penh is under construction.⁹

While visitor arrivals continued to increase, tourists visiting Angkor Wat temple declined

Driven largely by rising numbers of Chinese visitors, international arrivals accelerated to 11.2 percent y/y, up from 10.7 percent in 2018 (figure 7). Similar to the rising share of Chinese FDI inflows, Chinese visitors account for almost 40 percent of total international arrivals or 1.3 million tourists during the first six months of 2019. Arrivals from Vietnam, Lao PDR, and Thailand remained the next three largest, capturing 12.0 percent, 6.1 percent, and 5.2 percent of total international arrivals, respectively.

Figure 7: Tourist arrivals to Cambodia, Thailand, and Vietnam

(y/y, percent change)



Source: Cambodian authorities.

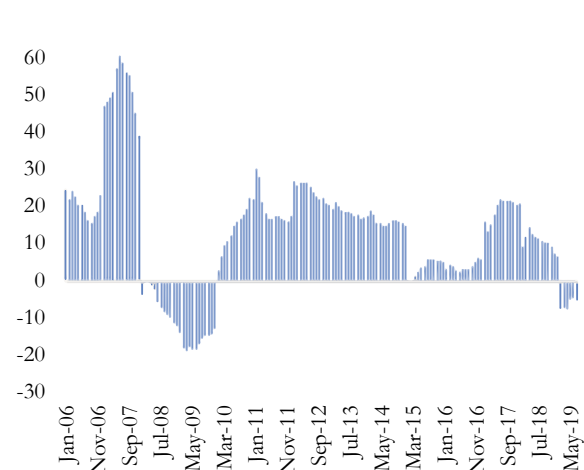
Visitors from the Republic of Korea declined by 20 percent (reflecting also a drop in South Korean investment in Cambodia), and the country is now ranked fifth, accounting for 4.2 percent of total international arrivals. Arrivals from Japan ranks sixth, accounting for 3.0 percent, with a 3 percent y/y increase. As a result, Cambodia's tourism sector continues to be dependent on tourists from Asia and Pacific which cover 82 percent of international arrivals, while those from Europe and the Americas capture only 12.4 percent and 5.7 percent, respectively.

The coastal regions are rapidly emerging visitor destinations, especially the provincial town of Sihanoukville. During the first six months of 2019, international arrivals to Sihanoukville skyrocketed, and the bustling town received about 300,000 visitors, or a huge 357.5 percent y/y increase (see box 2). As a share of international visitors to Cambodia, foreign tourists visiting Phnom Penh (and surroundings) rose to 50 percent in 2019, up from 46 percent in 2018, due to a rising share of visitors coming to Cambodia for business purposes.

However, tourists visiting Angkor Wat temple declined by 8.3 percent y/y during the first 6 months of 2019. Foreign tourists arriving at Siem Reap International Airport declined for the first time since the 2008/09 global financial crisis. Arrivals at Siem Reap dipped by 5.5 percent in

Figure 8: International arrivals to Siem Reap Airport

(YTD, y/y, percent change)



Source: Cambodian authorities.

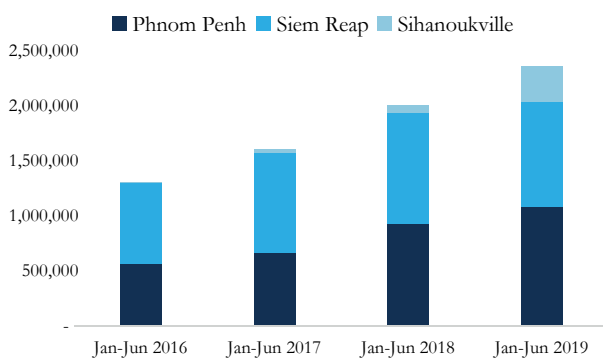
Note: YTD = year-to-date.

⁹ For more on the Phnom Penh - Sihanoukville expressway, see <http://www.mpw.gov.kh/kh/public-works/expressways>

Tourist attraction destinations: the emergence of Sihanoukville and the decline of Siem Reap

While the Angkor temple complex and Phnom Penh are still the main destinations, Sihanoukville has recently emerged as a key attraction site. During the first six months of 2019, international arrivals to Sihanoukville skyrocketed, and the rapidly growing town received about 300,000 visitors (figure S2.1) or a whopping 357.5 percent y/y increase. The Sihanoukville International Airport welcomed over 650,000 passengers (inbound and outbound) in 2018 and has experienced an intensive acceleration of its growth with triple-digit figures every year since 2016 with the opening of new international routes, especially to and from Chinese cities, and between Sihanoukville and regional metropolises like Kuala Lumpur and Ho Chi Minh City. The extension of the airport's runway to 3,300 meters is launched, while studies are underway for the building of a new passenger terminal scheduled to be commissioned in mid-2022.¹ The surge in international arrivals to Sihanoukville, however, appears to be fueled particularly by an investment boom, with bustling construction activity.

Figure B2.1: International arrivals to Cambodia's main airports



Source: Cambodian authorities.

In contrast, international arrivals by air to Cambodia's most visited attraction site of Siem Reap declined. Since early this year, the number of tourists visiting Siem Reap has started to decline for the first time since the 2008/09 global financial crisis. By mid-2019, tourist arrivals to Siem Reap, where the (World Heritage) Angkor temple complex is located, dipped by 5.5 percent y/y, although total tourist arrivals by air to the three main airports grew by 17.4 percent (total international arrivals to the country grew by 11.2 percent). While Cambodia is endowed with globally

significant resources for tourism that are diverse and well placed to be a pillar for socioeconomic development, the country was ranked low, at 98th in 2019 on the travel and tourism competitiveness index, compared to its neighbors, namely Lao PDR (97th), Vietnam (63rd) and Thailand (31st). This may indicate that the tourism sector needs boosting.

Repeat visits by foreign tourists to Cambodia improved slightly, rising from 16.2 percent in 2013 to 21.3 percent in 2018 (but remained nowhere near Thailand, whose repeat visits are for 60 to 70 percent²). However, there are some worrying trends. For example, length of stays remains short and have not changed much—5.4 days in 2013 to 6.4 days in 2018;—value captured per tourist has declined—from US\$809 in 2013 to US\$552 in 2018;—low-end businesses have mushroomed; and there are signs of degradation of the key assets at the Angkor temples. In addition, during the post-global financial crisis period, Cambodia's tourist arrivals growth decelerated, averaging 12 percent a year, compared to 20 percent per year in the pre-global financial crisis period. Recently, Cambodia's tourist arrivals have become increasingly dependent on Chinese visitors, which captured 32.6 percent of total arrivals with the y/y growth rate surging to 67.2 percent in 2018.

A 2017 study provided substantial anecdotal evidence that there is little formal integration by tourism enterprises along the vertical value chain.³ Destination management companies operating or owning accommodation and transport companies do not exist, and at most, tourism enterprises have two outlets (Phnom Penh and Siem Reap), often managed as a single entity. This reflects the way Cambodia is being offered to visitors, with limited overland travel and product development by operators around established destinations. Insufficient transport infrastructure and weak environmental services hold back sustainable and more inclusive tourism growth, as many secondary destinations are unable to attract private investment in quality tourist service infrastructure. This calls for immediate action to address the major constraints which appear to be insufficient public and private funding, weak coordination among tourism industry stakeholders, and low capacity to design and implement effective destination marketing campaigns.

¹ See <https://corp.cambodia-airports.aero/en/press-release/cambodia-airports-won-award-marketing-sihanoukville-airlines>

² See <https://www.travstore.com/how-to-construct-itinerary-for-repeat-travelers-to-bangkok/>

³ See Selected Issue section on maximizing tourism potential, October 2017 Cambodia Economic Update

the year to June 2019, compared to increases of 6.5 percent and 20.8 percent in 2018 and 2017, respectively (figure 8). As a share of international visitors arriving by air to Cambodia, tourists coming to Siem Reap declined to 40.4 percent in 2019, compared to 47.3 percent in 2018 and 55.0 percent in 2017. While it is a bit too earlier to draw any conclusions, the declining number of foreign visitors to Angkor Wat may indicate that the temple in Siem Reap, which had been the country's largest tourist attraction site, can no longer continue to attract tourists without additional products. In this regard, the authorities are studying the tourism master plan for Siem Reap province and have identified new potential tourism products, particularly in Kulen Mountain, the Tonle Sap area, and the areas located within the temples of Angkor. However, it is likely that additional investment in tourism infrastructure, services, and products will be needed.

Almost half of arrivals from China came for business purposes

In the first half of 2019, 42 percent of arrivals from China came to Cambodia for business purposes, compared to only a quarter in 2018. Visitors coming to Cambodia for business purposes increased to 21.0 percent in June 2019, up from 11.1 percent in December 2018 (figure 9). This indicates that Cambodia is increasingly attractive to (Chinese) investors, with their rising share of the total international arrivals. This is consistent with the rising share of FDI inflows from China that has supported the construction boom, as well as newly flourishing trade and investment activities established by Chinese small and medium-sized enterprises focusing primarily on building material, furniture, office equipment and household appliance products serving the newly constructed properties.

Substantial untapped potential in tourism remains. During the first six months of 2019, Cambodia received 3.34 million foreign tourists, but this accounts for a mere 10.5 percent of total international arrivals to the three regional

countries—Cambodia, Vietnam and Thailand. During the same period, Thailand and Vietnam received 19.7 and 8.5 million tourists, respectively. Investing more toward the provision of sufficient and well-functioning public tourism infrastructure, while improving cooperation between commercial and public entities, is likely needed to tap into this growing tourism market located at Cambodia's doorstep. For instance, a large investment plan (2016-20) of US\$24.0 billion (of which the state budget accounts for 8 to 10 percent) is being implemented by Vietnam to build and upgrade tourism and transport infrastructure in provinces with key tourist landmarks.¹⁰

Slower cultivation is due to less favorable weather conditions

Official statistics indicate that this year's cultivation of rainy season rice and supplemental and industrial crops was slower than last year.¹¹ By July 2019, rainy season rice cultivation reached 2.1 million hectares, which is 0.13 million hectares below 2018's cultivated area. This amounts to 81.8 percent of the authorities' target. However, the authorities are committed to boosting agriculture cultivation to meet this year's targets by providing agriculture extension services focusing on arable land areas ready for cultivation. Specifically, several measures have reportedly been introduced in this regard. They include training for extension officials and farmers, seed production, research and development, contract farming expansion including markets for agricultural products. Rice production continues to play an important role in Cambodia's agriculture sector as it accounts for about half of agriculture GDP, of which rainy season rice production covers 75 percent and dry season rice production covers the rest.

Rice production for 2018 increased to 10.8 million metric tons or 3.5 percent y/y (figure 10). This was 0.37 million metric tons higher than production in 2017, even though it was affected by midseason drought and floods in some parts of the country. Of the 0.37 million

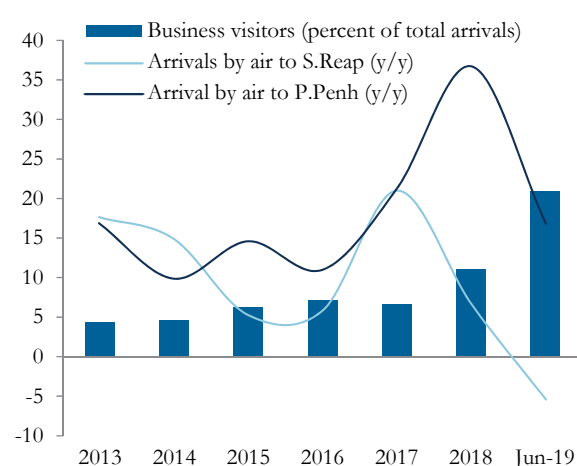
¹⁰ Decision No. 201/QĐ-TTg of January 22, 2013, approving the master plan on development of Vietnam's tourism through 2020, with a vision toward 2030.

¹¹ July 2019 report on agriculture, fisheries and forestry, dated August 16, 2019, Ministry of Agriculture, Fisheries and Forestry.

ton increase, 0.21 million tons was a result of increased yield and 0.16 million tons a result of land expansion (figure 11). Thus, in 2018, the improvements in yields reflect better or more efficient use of agricultural inputs. Yields of wet and dry season rice production increased by 1.7 percent and 1.0 percent, respectively. However, annual rice production growth halved, expanding at 4.1 percent after the global financial crisis, compared with 8.3 percent before global financial crisis. Cambodia exports only about 17 percent of its rice surplus in the form of milled rice. Its production of cassava (13.5 million tons) has until recently been exported unprocessed.¹² This indicates that much could be gained in terms of value added if the country were able to process its main agriculture commodities—rice and cassava—before export, although diversification to other agricultural products such as bananas and mangos for export shows some promising signs. Agricultural gross value added (at constant prices) decelerated to 1.2 percent in 2018, contributing only 0.24 percentage points to real GDP growth in 2018.¹³ Rubber and cassava production also expanded last year, rising by 16.6 percent and 2.6 percent, respectively.

Figure 9: Air and business visitor arrivals to Cambodia

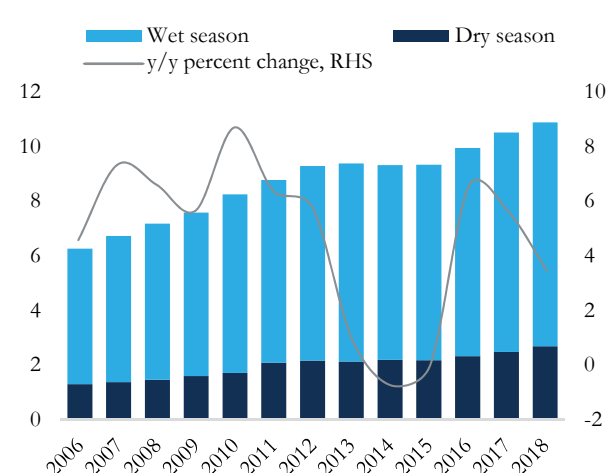
(y/y, percent change)



Source: Cambodian authorities.

There is untapped potential that could be exploited to diversify agriculture products as well as to expand livestock production, given increased market demand for animal products as household incomes rise. Rising income and urbanization and a rapid expansion of the tourism sector have led to rising demand for animal products. Domestically, this is reflected in the elevated (and past rapid increases in the) consumer price indexes for animal products such as beef, poultry, fish and seafoods, while consumer price indexes for cereals such as rice have remained subdued (figure 12). This is also true for exports due to expansion of the Asian and Chinese middle class. However, during the last decade or so, diversification toward production of animal products (and aquaculture) has been slow with a decline in livestock production for both family and commercial farms, despite rising demand and prices (table 1). Therefore, a well targeted national policy to promote agricultural diversification could play a crucial role to boost private and public investment and the expansion of animal products, underpinned by a favorable trade and export regulatory environment.

Figure 10: Annual rice production
(million metric tons)



Source: Cambodian authorities.

Note: RHS = Right-hand scale.

¹² A Hong Kong-based holding group is investing in building cassava processing plants.

¹³ Annual report, 2018 achievements and 2019 targets, Ministry of Agriculture, Forestry and Fisheries, March 2018.

Cambodia is a net importer of animal products. In 2018, the authorities estimated that the country imported 630,000 (live) pigs and combined chicken and duck imports of 37 million heads as it could only supply 81 percent of animal products demanded.¹⁴ As illustrated in table 1, overall production of livestock declined by 5.8 percent in 2018. The country is shifting away from raising cattle as draught animals to breeding them for meat production. Poultry production, however, increased 5.3 percent last year. Both livestock and poultry production that is produced commercially expanded slowly, though. During the past five years, the share of livestock and poultry that is raised commercially only gradually

increased, reaching 11.6 percent and 24.0 percent of total production in 2018, up from 3.2 percent and 22.4 percent in 2013, respectively.

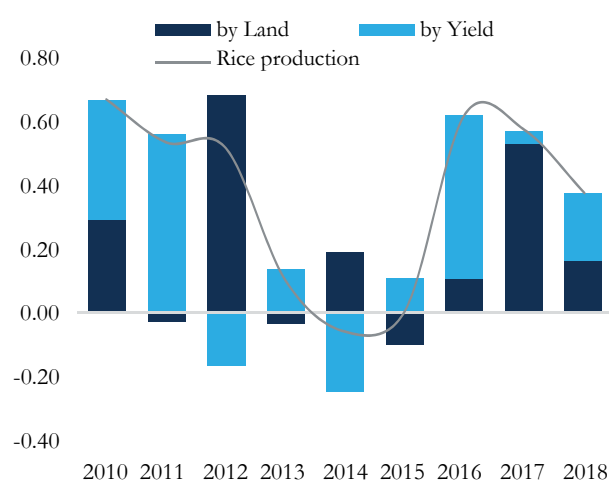
Depressed commodity prices continue to weigh heavily on the country's agriculture commodities exports. In addition, the European Commission (EC) has imposed safeguard measures on Cambodian rice.¹⁵ China, in contrast, increased its import quota for Cambodia's rice to 400,000 tons in 2019, up from 300,000 in 2018. Official statistics show that total milled rice exports reached a quarter of a million metric tons for the year to June, a 3.5 percent y/y decline. In value terms, the milled rice exports amounted to US\$200 million or a 9 percent y/y increase.

Table 1: Animal production (in thousand heads)

Livestock (cows, buffalos and pigs)				Poultry (chickens and ducks)			
Total	Family (percent)	Commercial (percent)	Total (y/y)	Total	Family (percent)	Commercial (percent)	Total (y/y)
2013	11,877	96.8%	3.2%	27,625	77.6%	22.4%	
2014	11,182	96.6%	3.4%	31,584	81.1%	18.9%	14.3%
2015	10,739	96.0%	4.0%	34,519	77.3%	22.7%	9.3%
2016	10,886	94.3%	5.7%	35,733	79.5%	20.5%	3.5%
2017	7,469	90.1%	9.9%	36,170	79.2%	20.8%	1.2%
2018	7,002	88.4%	11.6%	38,094	76.0%	24.0%	5.3%

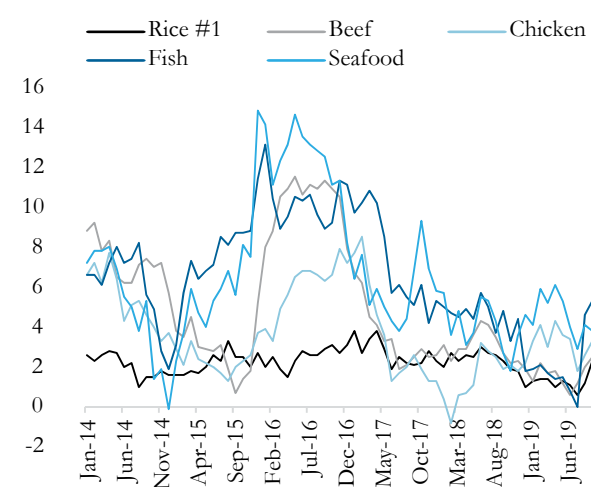
Source: Cambodian authorities

Figure 11: Contribution to total rice production increase
(in million metric tons)



Source: Cambodian authorities.

Figure 12: Elevated consumer price indices of chicken, beef, and seafood items
CPI (y/y, percent change)



Source: Cambodian authorities.

¹⁴ Annual report for 2018-19 and targets for 2019-20, Ministry of Agriculture, Forestry and Fisheries.

¹⁵ Press release, European Commission, January 19, 2019. See http://europa.eu/rapid/press-release_IP-19-427_en.htm

Cambodia continued to make inroads into poverty reduction

Poverty estimates for 2015-17 are currently under review by the authorities and preliminary indications are that poverty continues to decline. While Cambodia continued to make inroads into poverty reduction, progress during 2013-17 was less well than during 2009-13. The non-poor benefited more from economic growth during 2009-13, and urban poverty reduction stagnated.

Growth in labor income was the key driver of poverty reduction in Cambodia. Income decompositions show that wage and non-wage agriculture income were the main drivers of poverty reduction in Cambodia during the period of 2009-17, largely due to the higher average wage per worker and non-agricultural income per adult. Non-labor income also contributed positively to poverty reduction, but its contribution was smaller in the period 2013-17.

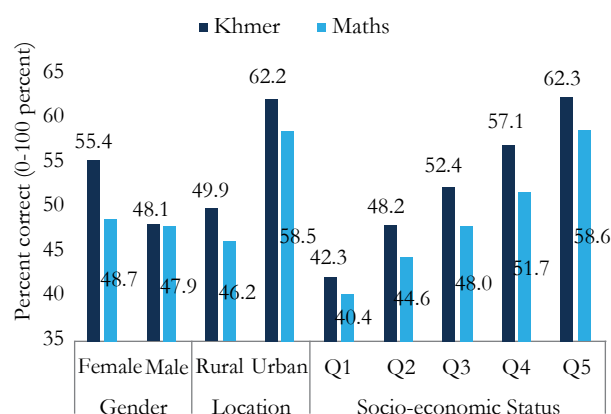
The importance of non-labor income differed completely between urban and rural areas. In the urban areas, declining non-labor income increased poverty between 2009 and 2013, before rising and helping to reduce poverty during 2013-17. Non-labor incomes had been rising throughout the rural areas, contributing to poverty reduction in both sub-periods. Remittance, a sub-component

of non-labor income, still reduced poverty rates in both urban and rural areas. The share of remittances to total household income increased from 3 percent in 2009 to 12 percent in 2017 – among the poorest households. The contribution of transfer to poverty reduction was very small, reflecting the weak public social protection programs.

Rural students performed less well, while maternal and child malnutrition remains severe among the poor

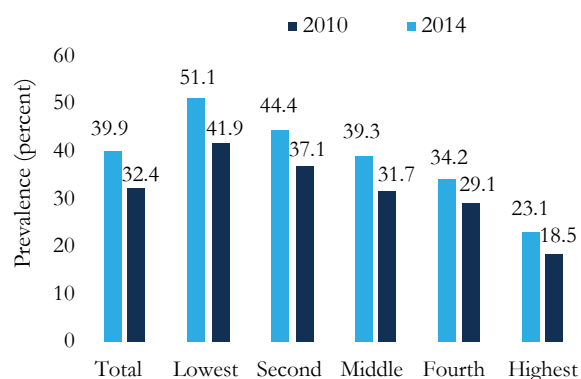
While primary school student performance significantly improved, rural students' test scores were about 12 percentage points lower than their urban counterparts. The national student learning assessment report finds that grade 6 student performance has improved significantly in mathematics but moderately in the Khmer between 2007 and 2016 (figure 13).¹⁶ Rural students, however, performed less well than their urban peers in both Khmer and mathematics, with test scores in rural areas about 12 percentage points lower than in urban areas. The most recent international assessment, the Program for International Student Assessment for Development (PISA-D), also found that 15-year-old urban students outperformed their rural peers in reading by 42 points—equivalent to more than a year of schooling.¹⁷

Figure 13: Grade six student achievements (percent, 2017)



Source: Cambodian authorities.
Note: Q1=lowest, Q5=highest.

Figure 14: Under five stunting (percent)



Source: National Institute of Statistics, Directorate General for Health and ICF International 2011, 2015.

¹⁶ Ministry of Education, Youth and Sports, 2017

¹⁷ Ministry of Education, Youth and Sports, 2018

While maternal and child malnutrition remains widespread in Cambodia, it is particularly severe among the poor and in rural areas, compounding disadvantages in the early years. About one-third of all children under age five are stunted, exceeding the World Health Organization threshold for “high” stunting. Many of these stunted children are from poor households and, at 42 percent, the prevalence of stunting among children under age five in the poorest quintile is more than double the stunting rate (18.5 percent) of children in the top quintile (figure 14).¹⁸

Inflation was subdued mainly on the back of easing food and petroleum prices

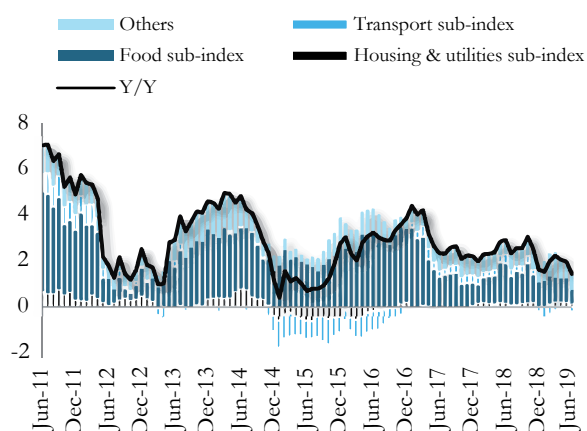
Despite strong internal demand, inflation has reached a four-and-a-half-year low. June 2019 inflation eased further to 1.4 percent, compared to 1.6 percent in 2018 (figure 15). In June 2019, inflation declined with the easing of food and petroleum prices. The food and non-alcoholic beverage subindex of Cambodia’s inflation basket decelerated to 1.1 percent in June 2019, compared with 1.9 percent in December 2018. Reflecting the easing of gasoline diesel prices, the transportation and telecommunication subindex fell into negative territory, declining by 2.5 percent y/y. Retail prices of gasoline and diesel also declined, helped by the easing of international oil prices, while

food prices eased, given depressed agricultural commodity prices. In addition, given the high level of dollarization in Cambodia, a strong U.S. dollar has also contributed to keeping inflation low.

In the East Asia and Pacific region, price pressures remained generally subdued across the larger regional economies, many of which are Cambodia’s trading partners, but have slowly increased since the start of the year.¹⁹

Headline inflation in the EAP region’s larger economies was lower in the first half of the 2019 compared to the first half of 2018 (figure 16). Inflation, however, has started to increase since the start of the year, except in the Philippines, which experienced a steady decline in inflation from a peak in the third quarter of 2018 (see also box 1). In China, while weaker energy prices exerted downward pressure on inflation in early 2019, strong food price growth contributed to higher inflation, especially in March and April. In Thailand, inflation remained near the low end of the central bank’s 1–4 percent target range, reflecting lower demand pressures with the slowdown of domestic activity. In Vietnam, driven by a moderation in food prices, headline CPI inflation remained subdued at 2.3 percent (y/y) in August 2019, down from 3 percent in December 2018. As China, Thailand, and Vietnam are Cambodia’s main trading partners (importers), subdued inflation in those countries

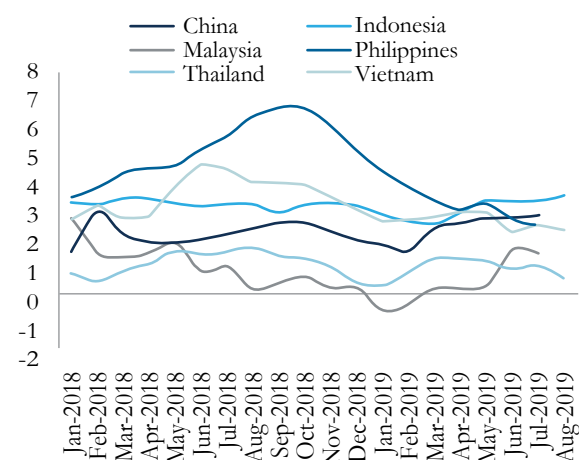
Figure 15: Inflation remained to be subdued
Contributions to 12-month inflation
(percent)



Source: Cambodian authorities.

Figure 16: Inflationary pressures have picked up in major economies

Headline inflation (end of period, y/y, percent)



Source: World Bank 2019d (October), World Bank, Washington, DC.

¹⁸ National Institute of Statistics, Directorate General for Health and ICF International 2011, 2015.

¹⁹ World Bank 2019d.

also helped contain inflationary pressures in Cambodia.

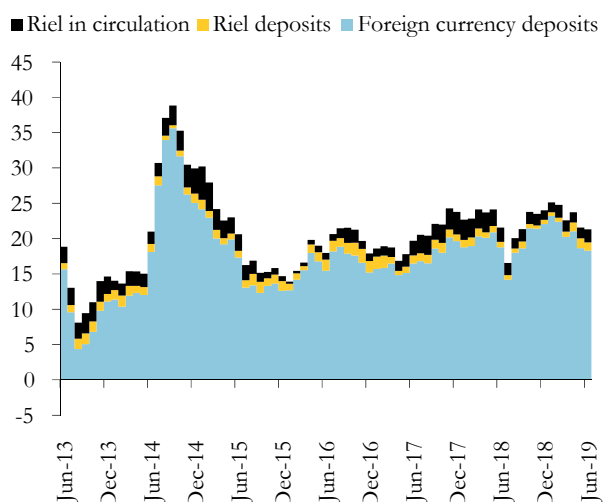
The easing of foreign currency deposits slowed broad money growth

Broad money growth eased slightly to 21.3 percent in June 2019, compared to 24.0 percent in 2018, thanks to decelerated foreign currency deposit growth. In June 2019, the contribution to broad money growth from foreign currency deposits, riel deposits, and riel in circulation was 18.3 percent, 1.2 percent and 1.8 percent, respectively (figure 17). While slower broad money growth seems seasonal, the rise of riel deposits is not. The contribution to broad money growth from riel deposits, amounting to 1.2 percent in June 2019 doubled, compared to 0.6 percent in December 2018 (and 0.8 percent in June 2018). Expansion of local currency deposits in broad money may actually reflect the initial success of the central bank in promoting the use of Cambodian riel.

The policy to promote the use of local currency is showing encouraging results

There are signs of the initial success of the central bank's policy to promote the use of the local currency in the highly dollarized

Figure 17: Contribution to broad money growth (percentage points)

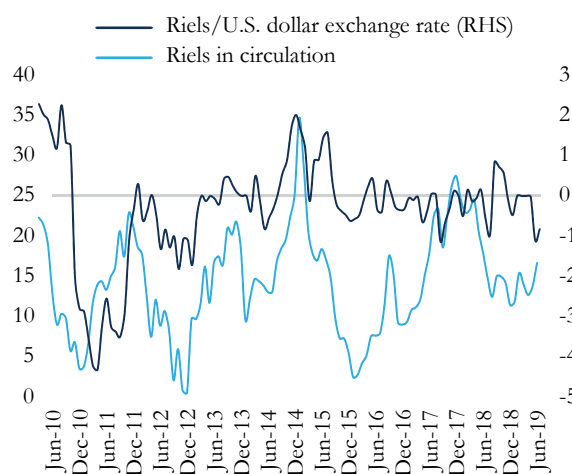


Source: Cambodian authorities.

economy. Although the contribution of the local currency in broad money growth remains relatively small, the central bank has recently been able to inject more local currency, while maintaining a broadly stable riel versus U.S. dollar exchange rate (figure 18). In December 2016, the central bank issued a Prakas²⁰ requires that all banking and financial institutions to have at least 10 percent of their total loan portfolio in national currency, effective December 31, 2019.²¹ To supply liquidity in local currency, the central bank has established a facility called the Liquidity-Providing Collateralized Operation (LPCO) aimed at establishing a benchmark rate of local currency borrowing for the market, while promoting the use of local currency. As the central bank requires Negotiable Certificates of Deposit (NCDs) — a short-term interest-bearing debt it issues as collateral, LPCO operations “sterilize” excess liquidity when additional volumes of riels demanded by the market are injected by the central bank.

A rapid expansion of LPCO is a good sign, as it shows that the demand for local currency is increasing. According to the central bank, during the first six months of 2019, LPCO operations amounted to 4 trillion riels, or an eleven-fold increase over the first half of 2018. By June 2019,

Figure 18: Riel in circulation and riel compared to -U.S. dollar exchange rate (y/y, percent change)



Source: Cambodian authorities.

Note: RHS = Right-hand scale.

²⁰ A Prakas is a regulation issued by head of public institutions such as Minister, or by the Governor of the central bank (<https://asianbondsonline.adb.org/regional/guides/definition.php?term=Prakas>).

²¹ Prakas issued by the National Bank of Cambodia) on Provision of Credit in National Currency of Banking and Financial Institutions, No. B7.016.334. PK, dated December 1, 2016.

Box 3.

Cambodian households' debt-to-income ratio

Rapid financial deepening during the post-global financial crisis period, with broad money growing at an average 20.7 percent during 2011-18, underpinned increased access to finance and accommodated economic growth. According to the central bank's mid-year report, by mid-2019, total outstanding credit reached 103 percent of GDP, 77.3 percent of which was provided by the banking sector, while the rest was supplied by the microfinance sector. In 2018, the banking sector served 6.2 million depositor' accounts and 2.6 million borrower' accounts. The microfinance sector provided credit to 1.8 million borrowers and obtained deposits from 2.1 million depositors.

In addition, costs of borrowing have declined substantially during the past several years as the efficiency of the banking and microfinance sectors has improved. The weighted average interest rate of U.S. dollar-denominated loans supplied by the banking sector declined to 7.07 percent per year in 2018, down from 17.15 percent per year at the end of 2010. In the past, rural households, especially farmers relied heavily on informal private money lenders who more often than not loan-sharked them. But the majority of rural households now obtain loans from the (formal) microfinance sector, although interest rates charged by the sector remain relatively higher than those of the banking sector. The 2017 Cambodia Socio-economic Survey found that the banking and microfinance sectors combined supplied almost 80 percent of the credit demanded by rural households (52.3 percent was provided by the microfinance sector and 26 percent by the banking sector).

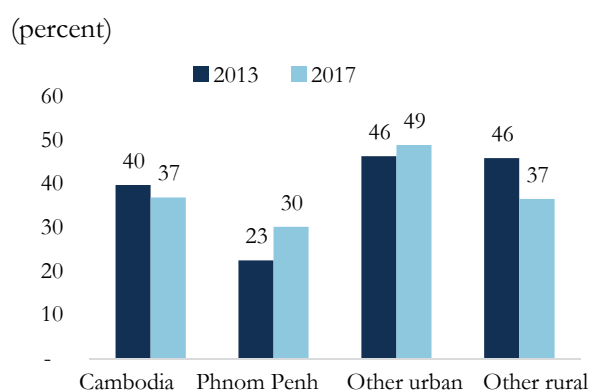
Lower borrowing costs have so far helped contain the debt-to-income ratio¹, as outstanding debt rises with increased access to finance by households. As credit is

increasingly being pumped into the economy, outstanding debt owed by each household increases. The 2017 Cambodia Socio-economic Survey found that average household (disposable) income growth averaged 12.1 percent during 2013-17 period, but households' outstanding debt expanded at a much faster rate, growing at an average of 24.8 percent per year. Nonetheless, the decline in interest rates helps contain debt repayment. Cambodia's debt-to-income ratio has been estimated to have slightly declined, but remains elevated for some geographic areas, namely other urban and other rural (figure B3.1). Elevated debt-to-income between 36 percent to 49 percent warrants household's efforts to lower it to be in a better position to handle unforeseen expenses.

More importantly, the use of loan proceeds by borrowers matters. Financial intermediaries channel savings into productive investment by providing liquidity in the form of credit. Loan proceeds used for productive purposes will then generate additional income which helps reduce the debt-to-income ratio in the longer term, all else being equal.

In Cambodia, rising credit may not necessarily be supportive of future income generation. The 2017 Cambodia Socio-economic survey showed the share of loan proceeds used for agricultural and nonagricultural activities, which provided almost 40 percent of household's income in the rural areas, declined. For rural households, the share of loans provided for agricultural and nonagricultural activities declined from 43.5 percent of total credit in 2013 to 30.2 percent in 2017 (figure B3.2). In contrast, the share of loans provided for consumer durables rose from 12.4 percent to 24.7 percent in 2017. For Phnom Penh, the share of loans provided for household consumption needs rapidly expanded, rising from 18.6 percent in 2013 to 55.1 percent in 2017. Therefore, financial literacy needs to be improved.

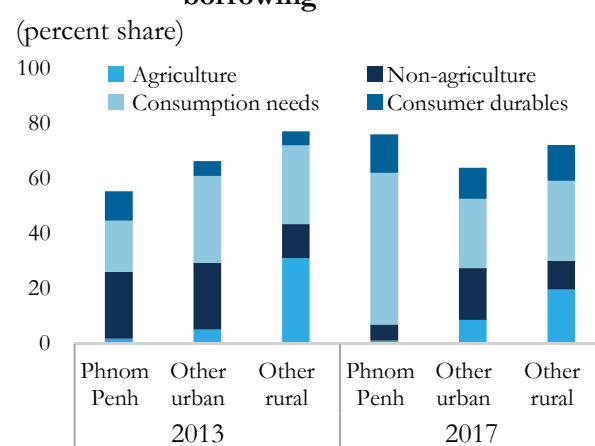
Figure B3.1: Estimated debt-to-income ratio



Source: World Bank staff estimates using 2017 CSES.

^{1/} Debt-to-income ratio is all monthly debt payments divided by gross monthly income.

Figure B3.2: Outstanding debt by purpose of borrowing



Source: 2017 Cambodia Socio-economic Survey.

NCDs reached US\$3.5 billion for U.S. dollar-denominated NCDs and 3.5 trillion riels for and riel-denominated NCDs. A rising demand for local currency has led to a 6 percent increase y/y of U.S. dollar-denominated NCDs (used as collateral by banks for LPCO operations) a 21 percent reduction y/y of riel-denominated NCDs. The rapid accumulation of gross international reserves which reached US\$11.3 billion or a 24.7 percent y/y growth, the fastest increase since February 2018—is due at least in part to the increase in use of local currency. The use of local currency could be further expanded, if all banking and financial institutions were required to increase the share of their loan portfolios in the national currency to more than 10 percent. Doing this will enable the central bank to further accumulate gross international reserves, while gradually de-dollarizing the economy.

The exchange rate remained broadly stable

To keep the riel-U.S. dollar exchange rate stable, the central bank conducts prudent market operations. During the first half of 2019, 2.0 trillion riels (equivalent to US\$518 million) was supplied by the central bank to commercial banks and money changers.²² Due to a seasonal factor, there was a slight depreciation of the riel versus the U.S. dollar exchange rate in June 2019, when the exchange rate reached riel 4,066 per U.S. dollar, compared with riel 4,018 per U.S. dollar at the end of 2018. The riel also marginally depreciated against the Thai baht but appreciated against the Vietnamese dong (figure 19). Against the currencies of its main export markets (besides the United States), the riel appreciated against the euro, the Canadian dollar, and the British pound. Cambodia's nominal effective exchange rate remained largely unchanged, which indicates that relatively stable local currency against the weighted basket of currencies of Cambodia's trading partners.

Interest rates on riel-denominated loans declined, thanks to the promotion of local currency

The (weighted average) interest rate of riel-

denominated loans of the banking sector declined substantially, decreasing to 14.14 percent in June 2019, down from 16.4 percent in 2018. The central bank successfully injected an increasingly large amount of local currency, while maintaining a stable riel versus U.S. dollar exchange rate. Despite acceleration of domestic credit, banks' short-term interest rates for dollar-denominated loans remained broadly stable at 10.0 percent thanks to rising competition. The overall trend is that lending rates are gradually declining as banks compete and the banking system continues to strengthen and expand. The microfinance sector's interest rates are higher than those of the banking sector. In June 2019, the microfinance sector's interest rate of riel-denominated loans was as high as 17.7 percent, while the sector's interest rate of U.S. dollar denominated loans remained at 16.9 percent. Note the current interest rate cap imposed by the central bank is 18 percent.²³ Interest rates of riel- and U.S. dollar-denominated deposits of the banking sector were largely unchanged at 6.1 percent and 4.5 percent, respectively. Similarly, interest rates of riel- and US-dollar denominated deposits of the microfinance sector were broadly stable at 7.9 percent and 7.7 percent, respectively.

Credit growth accelerated and outstanding loans exceeded 100 percent of GDP

Driven by rising demand for credit fueled by Cambodia's booming economic activity, lending to the private sector increased further. Credit growth accelerated, reaching 28.3 percent y/y in June 2019, compared with 24.2 percent in 2018 and 19.6 percent in 2017. Credit growth has started to accelerate again since the second half of last year, mirroring the rise of credit to the construction and real estate sector (figure 20).

The construction and real estate sector received the largest share of bank credit

In June 2019, bank credit going to the combined construction, real estate and mortgage businesses captured the largest share, at 29.5 percent of the total US\$21.9 billion in bank credit provided to Cambodia's nonfinancial

²² First semester report, the National Bank of Cambodia, 2019.

²³ See Prakas on interest rate ceiling on loan at https://www.nbc.org.kh/download_files/legislation/prakas_eng/Prakas-on-Interest-Rate-Cap-Eng.pdf

sector. Before 2008/09 global financial crisis, the share of domestic credit going to the construction peaked at 22.8 percent when the construction boom went bust. By mid-2019, the total outstanding credit provided to the construction, real estate and mortgage businesses amounted to US\$6.45 billion with a growth rate of 38.9 percent y/y, contributing a record high of about 40 percent of bank credit growth. Bank credit going to retail and wholesale was next, capturing 15.8 percent and 11.4 percent, respectively. Credit to the agriculture and manufacturing sectors ranked fourth and fifth, accounting for 6.9 percent and 5.1 percent, respectively.

Rapid financial deepening led to the rise in outstanding loans financed by the banking and microfinance sector. Domestic credit growth was rapid, far exceeding nominal GDP growth. Total outstanding loans reached 103 percent of GDP or 111.3 trillion riels by June 2019, up from less than a quarter of GDP a decade ago. Cambodia's credit-to-GDP overtook several large economies in the region such as India, Indonesia, Pakistan and the Philippines, despite the country's nascent banking sector. The banking sector provided 77.3 percent of outstanding loans, and the microfinance sector provided the remaining 22.7 percent. This, however, excludes credit provided by the "shadow banking"

system introduced by real estate developers, rental and leasing firms, and informal lenders. Therefore, the magnitude of total credit provided is much greater, and the economy is highly leveraged (see also box 3 on Cambodian households' debt-to-income ratio).

Reported nonperforming loan (NPL) ratios for the banking sector marginally increased.

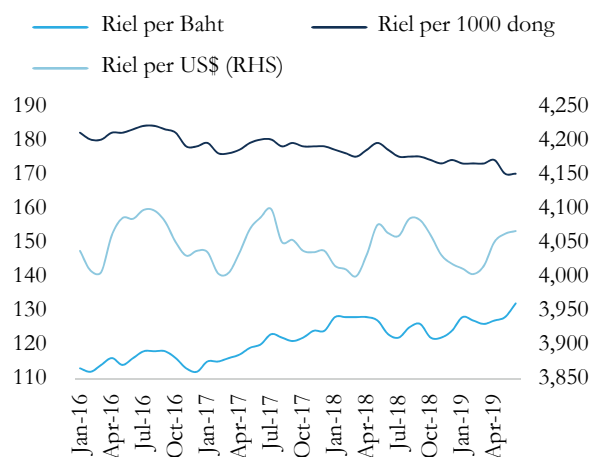
Reported NPL ratios for the banking sector declined slightly to 2.3 percent in the first half of 2019, compared with 2.8 percent in 2018.²⁴ Reported NPLs for the microfinance sector deteriorated slightly to 1.1 percent, increase from 1.0 percent in 2018. Still, the reported NPL ratios need to be carefully interpreted as there are inconsistencies in loan classifications and a continuous rolling over and refinancing of loans.

Cambodia has maintained adequate foreign reserve buffers, according to the Financial Stability Review

Continued efforts have been made to maintain the stability of the financial sector while promoting the use of local currency and making inroads into dollarization. The central bank's financial stability review indicated that volatility in the global financial market has not affected capital inflows and local currency movements in a

Figure 19: Riel appreciated against the dong but depreciated against the Baht

nominal exchange rates (Riels vs US dollar, Dong and Baht)

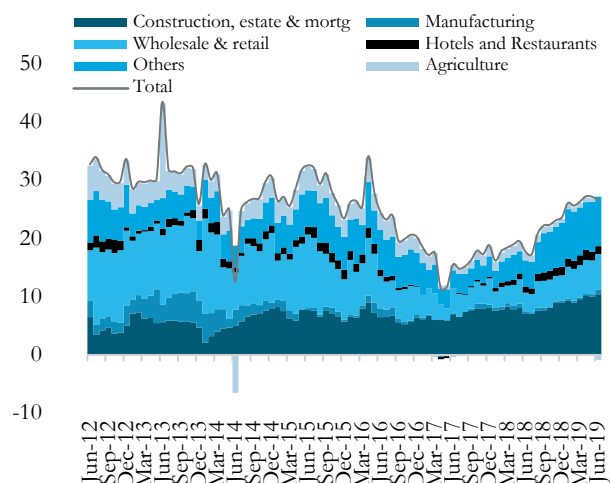


Source: Cambodian authorities.

Note: RHS = Right-hand scale.

Figure 20: Contribution to domestic credit growth

(percentage points)



Source: Cambodian authorities.

²⁴ 2019 Mid-Year Report, the National Bank of Cambodia.

noticeable way and that Cambodia has maintained an adequate international reserve buffer.²⁵

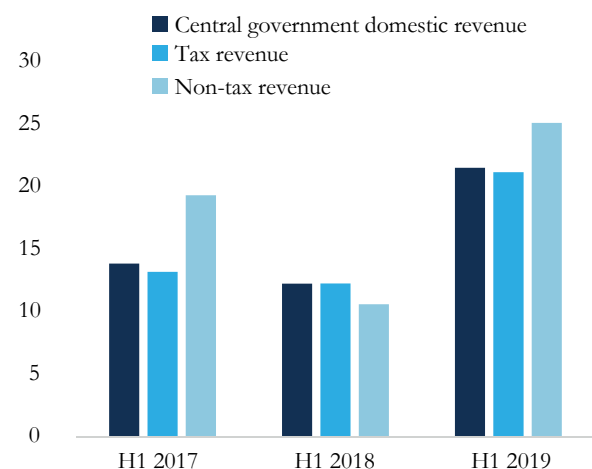
Potential macroprudential policies discussed in the financial stability review include both on the supply side (higher risk weights could be imposed on loans to construction and real estate-related sectors) and the demand side (credit quality and lending standards improvements), while fiscal policy is also considered important to address potential vulnerabilities in the real estate sector. New minimum capital requirements were fully in place by the first quarter of 2018. The central bank also conducted a stress test that showed that banking and financial institutions are resilient, except for a few institutions that need to be carefully monitored. Additional measures include a liquidity coverage ratio introduced in 2015 and steadily increased until 2020, and the strengthening of monitoring of currency and maturity mismatches.²⁶

Strong revenue collection has happened across-the-board

Revenue collection during the first six months of 2019 accelerated, reaching 11,452.4 billion riels or a 21.0 percent year-on-year increase (figure 21). Underpinned by the authorities' efforts to modernize tax and customs administration together with rising consumption

Figure 21: Recorded central government revenue has grown rapidly. First six-month collection

(y/y, percent change)



Source: Cambodian authorities.

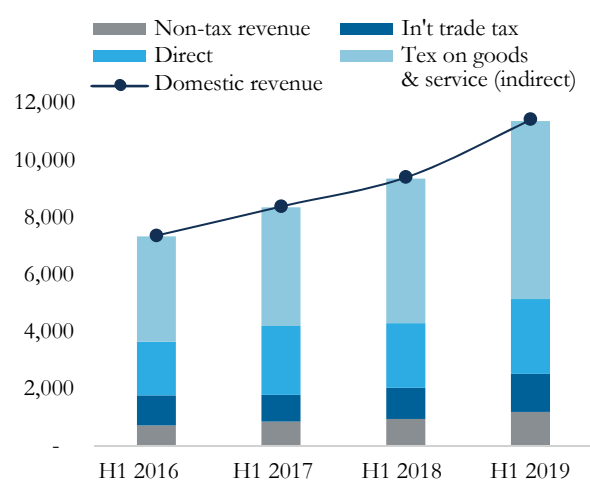
Note: H1 = First half.

and investment demands, this year's revenue performance markedly improved. There have been across-the-board improvements in revenue collection. Thanks to rising imports fueled by strong demand for durable goods such as motor vehicles, together with construction materials imports driven by bustling construction activity, revenue from taxes on goods and services (indirect taxes) accelerated. Taxes on goods and services, which comprises largely value-added tax (VAT) and excises accounts for the largest source of domestic revenue (54.4 of the total), reached 6,234 billion riels or a 23.1 percent y/y increase in June 2019 (figure 22).

Revenue from direct taxes, covering mainly profit and salary taxes and accounting for 22.8 percent of domestic revenue is next, rising to 2,615 billion riels or 15.8 percent y/y. Despite the commitment under the ASEAN Free Trade Agreement (AFTA), revenue from the international trade tax which includes mainly customs duties and fees and accounts for 11.7 percent, grew at 22.7 percent y/y. Non-tax revenue, the fourth-largest component, capturing 10.5 percent of total revenue, grew at 25.1 percent y/y. The authorities continue to reform and modernize revenue administration, while enhancing taxpayer services with the use of the banking system for tax payments. E-tax services have been introduced

Figure 22: Recorded taxes on goods and services (indirect tax) drove central government revenue. First six-month collection

(billions of riels)



Source: Cambodian authorities.

Note: H1 = First half.

²⁵ Financial Stability Review, the National Bank of Cambodia, 2018. See <https://www.nbc.org.kh/publications/fsr.php>

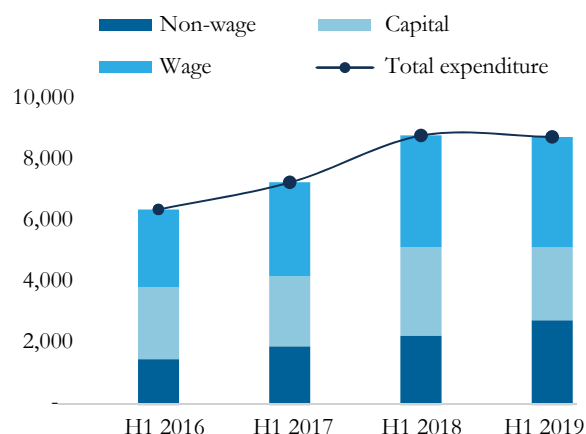
²⁶ Annual Reports for 2017 and 2018, the National Bank of Cambodia. See https://www.nbc.org.kh/english/publications/annual_reports.php

and supported by taxpayers' education, covering tax returns, tax registrations, and e-VAT, risk-based audits, and improved compliance. The capacity of tax and customs officials has also been strengthened. The 2019-23 Revenue Mobilization Strategy (RMS) has been adopted, a key objective of which is to further modernize tax and customs administration and policy. Given the rapid growth of revenue collection during the past several years, the new RMS conservatively aims at a lower target, an additional 0.3 percent of GDP revenue increase per year, compared with 0.5 percent set in the previous RMS.

Expenditure performance remained prudent

Overall public outlay reached 8.8 trillion riels during the first six months of 2019 (figure 23). Compared with the same period last year, the outlay was flat. While current expenditure managed to grow at 7.7 percent y/y, capital expenditure declined by 17.6 percent. By June 2019, non-wage disbursement accelerated, increasing by 22.0 percent y/y, thanks largely to rising disbursements for social benefits that consist mainly of social security and social assistance after they were split from wage and compensation budget nomenclature starting this year (figure 24). With the reclassification whereby social security and social assistance were split from the (original)

Figure 23: Recorded central government expenditure was flat due to slow capital budget disbursement. First six-month collection
(billions of riels)



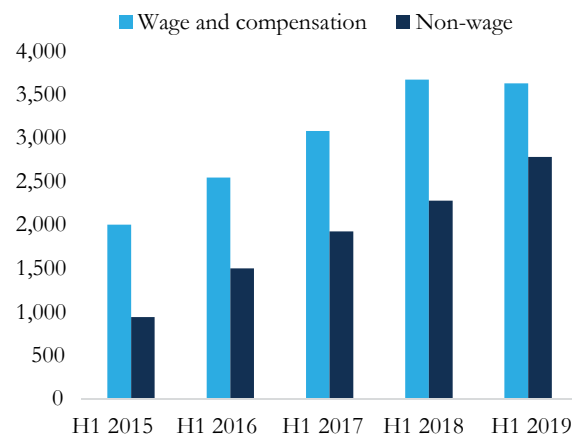
Source: Cambodian authorities.
Note: H1 = First half.

wage budget, the (reclassified) wage bill decreases to 7.6 percent of GDP (compared to 8.6 percent of GDP in 2018). In addition, this year's recorded wage disbursement was slow, reaching, as of June 2019 only 46 percent of the 2019 budget.

Disbursement of capital expenditure, accounted for about a third of the 2019 budget during the first six months, was also slower than last year's performance. By June 2019, disbursement for the 2019 capital budget reached only 30 percent of the 2019 annual budget, or a decline of 17.6 percent y/y. The slow disbursements were recorded for both domestically and externally financed capital spending, which reached 20.4 percent and 34.6 percent of the 2019 annual budget, respectively. Nevertheless, disbursement of capital budget often accelerates during the second half of each year as the procurement process picks up. As a result, annual capital disbursement eventually reaches the budgeted capital spending. Cambodia continues to depend on development partners to finance its capital investment. In the 2019 budget, externally financed capital spending accounts for about 75 percent of the total capital budget, while the remaining 25 percent is financed by domestic funds.

The overall fiscal deficit is expected to remain steady at two-year lows

Figure 24: Recorded non-wage spending increased thanks to budget reclassification this year
(billions of riels)



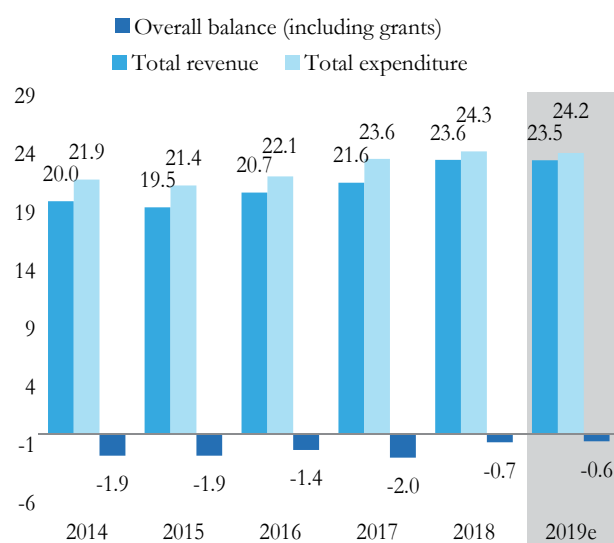
Source: Cambodian authorities.
Note: H1 = First half.

This year's overall fiscal deficit of the general government will remain largely unchanged with sustained revenue collection and prudent expenditure management. Revenue collection (including grants) is projected to sustain at 23.5 percent of GDP, similar to the level collected last year. Public outlays will remain contained at 24.2 percent of GDP. Cambodia's fiscal deficit (including grants) is therefore anticipated to stay steady at two-year lows, reaching 0.6 percent of GDP in 2019. The deficit remained to be fully financed by external funds (figure 25). After years of prudent fiscal management, the government has succeeded in rapidly accumulating substantial deposits at the central bank, which currently stand at 17.3 percent of GDP in 2019 (figure 26). The authorities are prepared to use part of the deposits as a fiscal stimulus in 2020 to mitigate the potential negative impacts of the withdrawal of EBA, if the latter occurs.

The debt distress level remained low as per the 2018 World Bank/IMF Debt Sustainability Analysis

The Debt Sustainability Analysis (DSA) using the revised joint IMF/World Bank Debt Sustainability Framework for Low Income

Figure 25: The general government fiscal deficit is expected to narrow, thanks to good revenue collection
(percent of GDP)



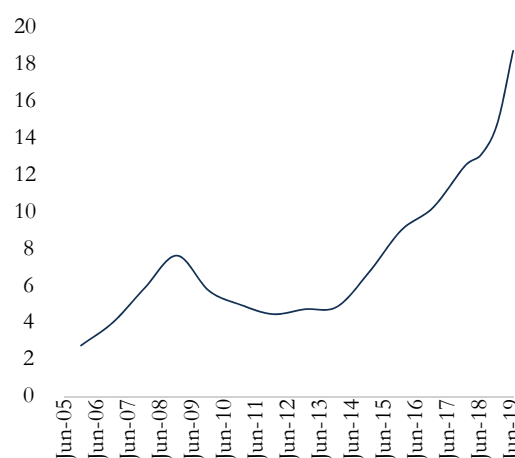
Source: Cambodian authorities and World Bank staff estimates.
Note: e = estimates.

Countries (LIC-DSF) showed that Cambodia remains at low risk of external debt distress.

All debt burden indicators are projected to remain under their indicative thresholds under the baseline and the shock scenarios. While the overall risk of debt distress is low, the analysis indicates that debt sustainability is vulnerable to export and growth shocks, and the materialization of contingent liabilities. Furthermore, the public and publicly guaranteed debt-to-GDP ratio is projected to rise by more than 10 percentage points during the next decade due to projected large fiscal deficits in the medium term. These findings reinforce the importance of implementing reforms to increase the economy's resilience to external shocks and encourage export and economic diversification. Efforts to mobilize fiscal revenue, to strengthen the Public Investment Management framework (including for PPPs) and further enhance monitoring of PPP and financial sector risks, as well as introduction of a debt-based fiscal anchor, are necessary to ensure debt sustainability in the medium term.²⁷

By end-2018, Cambodia had a total public debt outstanding of US\$7.02 billion (or 26.3 percent of GDP) of which 0.04 percent is public

Figure 26: Government deposit rose, thanks to increased collection Government deposit at the banking system
(percent of GDP)



Source: Cambodian authorities.

²⁷ IMF Staff report for the 2018 Article IV consultation - Debt Sustainability Analysis. See <https://www.imf.org/en/Publications/CR/Issues/2018/12/17/Cambodia-2018-Article-IV-Consultation-Press-Release-Staff-Report-Staff-Statement-and-46478>

domestic debt.²⁸ Overall, the borrowing terms remained highly concessional, with a (weighted average) interest rate, maturity and grade period of 1.24 percent, 27.0 years, and 7.5 years, respectively. By major currencies, outstanding debt in U.S. dollar is the largest, accounting for 44.2 percent of total outstanding debt. Special Drawing Rights and Chinese yuan are next, covering 27.2 percent and 15.1 percent, respectively.

China is the largest creditor, accounting for half of Cambodia's outstanding debt

Cambodia's external public debt owed to China accounted for 48.7 percent of total outstanding public debt by end-2018. The second- and third-largest creditors are multilaterals, namely the Asian Development Bank and the World Bank, covering for 18.9 percent and 7.8 percent of total outstanding debt, respectively. The fourth- and fifth-largest creditors are the Republic of Korea and Japan, accounting for 5.2 percent and 4.7 percent of total outstanding debt, respectively. Old debts (under negotiation) account for 8.8 percent.

The European Union and the United States remain Cambodia's largest export markets

The trade preferential treatments offered by the European Union and the United States have been largely behind Cambodia's success in boosting its exports (see also the special focus section below). Although there has been some progress on export diversification to China, Japan and ASEAN (table 2), Cambodia continues to rely on the European Union and the United States as its largest export markets. Cambodia's exports to China, Japan, Canada and ASEAN combined covered only one third of the country's total exports in 2018, up from a quarter in 2014. Both the EU and U.S. remain Cambodia's main export markets which combined accounted for 54.6 percent of total exports in 2018, slightly lower than 56.2 percent of total exports in 2014. As Cambodia's access to the EU market under the EBA arrangements is now uncertain with the possible EBA withdrawal, the country's export outlook is under threat.

The economy has increasingly relied on the construction and real estate sector which contributed about one fifth of real growth in 2018, up from one sixth in 2013. In addition, FDI inflows which have been largely originated from China and partly behind construction and real estate boom, peaked in 2018 and are expected to moderate amid weakening global demand, heightened trade policy uncertainty and slower projected growth in China. It is estimated that Cambodia receive as much as half of the total FDI inflows from China in recent years. Given the recent FDI inflows have mainly financed the non-tradeable sector, many of the advantages associated with FDI inflows such as technological transfers, skills, and management expertise which contribute to improving the country's external competitiveness remain limited. In addition, if the share of the construction and real estate sector in the economy declines, there will be implications for sustained economic activity and for employment.

Table 2: Cambodia's exports to its main destinations

(percent share)

Country/region	2014	2015	2016	2017	2018
EU	27.0	28.8	30.8	31.5	31.4
o/w UK	11.0	10.2	9.5	8.9	7.4
United States	29.2	25.0	21.3	21.4	23.2
China	7.6	6.9	8.2	8.8	10.1
Japan	5.0	6.7	8.2	7.6	8.2
Canada	7.4	6.4	6.5	6.7	6.6
ASEAN	5.3	9.0	8.6	7.9	6.1
Thailand	0.7	4.1	4.2	3.7	2.8
Vietnam	1.4	2.2	2.3	2.3	1.7
Malaysia	1.8	1.6	1.0	1.1	1.0
Singapore	1.0	0.7	0.6	0.1	0.0
Korea, Republic of	1.8	1.6	1.6	1.7	1.8
Other	16.6	15.6	14.7	14.4	12.6
Total	100.0	100.0	100.0	100.0	100.0

Source: Direction of Trade Statistics, IMF.

²⁸ Ministry of Economy and Finance 2019.

Outlook

With slower global demand, the growth outlook is projected to ease

The economy is expected to decelerate gradually in the short to medium term. Cambodia's exports will moderate with the easing of global demand, while investment decelerates with sluggish capital inflows due to slower projected growth in China. Growth is projected to ease to 7.0 percent in 2019, compared to 7.5 percent in 2018 (table 3). The easing of exports and continued strong growth in imports will result in a widening of the country's current account deficit to 9.8 percent of GDP in 2019, up from 9.4 percent of GDP in 2018, but remains fully financed by foreign direct investment. However, in the developing East Asia and Pacific region, Cambodia is projected to remain the fastest growing economy during 2019-21 (table 4).

Table 3: The macro outlook in the short and medium term is relatively stable

Percent of GDP unless specified otherwise	2019	2020	2021
GDP growth (percent)	7.0	6.8	6.8
Domestic demand (percent change y/y)	11.7	12.5	9.0
Inflation (percent change, average)	2.1	3.1	3.0
Overall fiscal balance	-0.6	-4.9	-4.5
Government debt	30.0	30.1	31.1
Export growth (percent change)	9.3	8.2	8.9
Import growth (percent change)	7.7	7.7	7.7
Current account	-9.8	-12.5	-12.0
FDI	11.8	11.9	11.4
Gross international reserves (months of imports)	5.6	5.6	5.5

Source: WDI, World Bank/IMF DSA and World Bank staff estimates and projections.

As illustrated in table 3, a relatively large fiscal stimulus to be financed by government savings is expected to be introduced in 2020²⁹ to mitigate potential negative impacts of the withdrawal of EBA. In February 2019, the EU launched the process that could lead to the temporary withdrawal in 2020 of Cambodia's preferential access to the EU market through the Everything But Arms (EBA) initiative. The stimulus will help growth remain robust in the short term.

Poverty reduction is expected to continue.

Economic growth, particularly growth in labor income in the form of higher wage income, is the main driver of poverty reduction. Most of the poor have wage income with low-paying jobs, signaling challenges with low skills and productivity. Inequality is on the rise in both urban and rural areas with the largest increase is in the rural areas.

Table 4: East Asia and Pacific Economic Outlook

	2018	2019p
Cambodia	7.5	7.0
Fiji	3.2	3.4
Indonesia	5.2	5.1
Lao PDR	6.3	6.5
Malaysia	4.7	4.6
Mongolia	6.8	6.9
Myanmar	6.5	6.6
Papua New Guinea	0.3	5.1
Philippines	6.2	5.8
Solomon Islands	3.5	2.9
Thailand	4.1	2.7
Timor-Leste	-1.1	4.2
Vietnam	7.1	6.6

Source: World Bank 2019d.

²⁹ Ministry of Economy and Finance's presentation on the macroeconomic framework and public finance policy at the National Assembly, July 15, 2019.

Risks

Risks are rising due to possible EBA withdrawal, a China slowdown, and a prolonged construction and property boom

Downside risks, arising from domestic and external factors have intensified.³⁰ Possible withdrawal of the EBA initiative, as well as a sharp slowdown in the Chinese economy (a potential outcome of continued U.S.-China trade tensions), could substantially dampen growth prospects, given Cambodia's reliance on exports to the EU and Chinese FDI inflows and tourists. Recently, high-frequency indicators have suggested a further moderation in economic activity in China. In addition, a prolonged construction and property boom and the increase of credit provided to the construction and real estate sectors alongside rising indebtedness—where combined bank and microfinance credit now accounts for over 100 percent of GDP—also present a downside risk for Cambodia.

Policy approaches to managing rising risks

Macro-prudential measures are needed to ensure financial stability in Cambodia's highly-leveraged economy. The latest financial stability review discussed potential macroprudential policies on both the supply and demand sides, while emphasizing the importance of effective interagency coordination. For a supply-side macroprudential policy, an example of a widely used tool in other countries is a sectoral capital requirement measure, where higher risk weights could be imposed on loans to construction and real estate-related sectors. To mitigate potential risks of speculation and

safeguard sound lending practices, demand-side macroprudential measures have been under consideration. Equally important, fiscal policy could be used to deal with potential vulnerabilities in the real estate sector. For instance, last year, Singapore introduced property cooling measures by raising the rates of the Buyer's Stamp Duty currently levied on all purchases of properties, except its citizens and permanent residents who are purchasing their first home.

It is imperative to improve the country's external competitiveness by facilitating investment and trade, while enhancing the ease of doing business. Cambodia's ranking in the ease of doing business index continued to slip, declining to 144th in 2019, down from 127th in 2016, when the country's ranking improved from its 135th ranking in 2015. The authorities recently introduced measures to facilitate trade by lowering logistics costs and supporting businesses with a six-day reduction in the number of publicly observed holidays next year. Successful implementation of the measures, together with more efforts to address high electricity costs and large skills gaps, will further promote investment in high-value-added products, especially the newly emerging and expanding products such as footwear, travel goods, electrical appliances and components, and auto parts. Advancing Cambodia's participation in regional and global value chains is needed to improve productivity in the presence of rising wages. See also the special focus section below on Upgrading Cambodia in global value chains that discusses the country's opportunities and challenges to upgrading in the apparel, footwear, and travel goods sector.

³⁰ EBA withdrawal (and fiscal stimulus) is not factored in.

ក្រុមហ៊ុនផលិតផលវេជ្ជប្រដាប់គ្រុប (ខេមបូឌា)
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JIANGXI 3L MEDICAL PRODUCTS GROUP (CAMBODIA) CO., LTD.

Special Focus:

Upgrading Cambodia in Global Value Chains



Special Focus: Upgrading Cambodia in Global Value Chains³¹

1. Introduction

Global value chains (GVCs), or the fragmentation of production across countries, are not new. However, they grew swiftly after 1990 due to technological advances in transportation and information and communications, and reductions in trade barriers that allowed manufacturers to extend production processes beyond national borders (World Bank 2019a). This has fundamentally changed how countries participate in international trade, the determinants of that participation, and the consequences for development (see box S1).

Emerging technological advances and shifting trade policies are reshaping international trade yet again. Notable are (a) the arrival of labor-saving technologies such as automation and 3D printing, and (b) increased protectionism among large countries. Their implications, though, are surrounded by uncertainty. *The World Bank's World Development Report 2020: Trading for Development in the Age of Global Value Chains* considers how important GVCs have been and can continue to be for countries' development given these evolving global megatrends (World Bank 2019a).

Cambodia—among the most open countries to trade in the world—embraced GVCs, which supported growth and other development outcomes, but with relatively little diversification or upgrading since. This special focus draws on the findings and policy insights of *the World Development Report 2020* and considers key policy areas to support Cambodia's continued development through GVC participation.

2. Lots of participation

Cambodia's participation in GVCs has grown steadily since the 1990s following the arrival of the export-oriented garment and footwear industry. An example of Cambodia's backward

participation in the garment value chain is firms that import textiles from China used to assemble t-shirts that are then exported to the United States as final products. Measures of backward GVC participation show that the foreign value added in Cambodia's exports grew from US\$5 million to US\$523 million between 1990 and 2015 (the latest year of available data). Measures of forward GVC participation show that the domestic value added in third countries' exports grew from US\$16 million to US\$456 million. An example of Cambodia's forward participation in the food and beverage value chain is firms that export unprocessed cassava to Thailand that is processed into chips and exported. But participation grew particularly swiftly starting around 2004 (figure S1).

Forward and backward GVC participation grew faster in Cambodia than in other regional countries such as Malaysia, Thailand, and Vietnam, as well as other developing countries such as Bangladesh and Sri Lanka, although from a low base (figure S2). Between 1990 and 2015, backward GVC participation grew twice as fast as these comparator countries, at an average annual growth rate of 21 percent. Foreign GVC participation, at 14 percent, also surpassed other countries' performance.

As in many countries, trade openness and GVC integration in Cambodia coincided with better economic performance. Cross-country growth regressions suggest that a 10 percent increase in backward and forward GVC participation is associated with a 13.6 percent and 10.5 percent increase in GDP per capita, respectively (World Bank 2019a). Both forms of GVC participation are associated with higher income growth than standard trade (World Bank 2019a). In Cambodia, GDP per capita growth in constant 2010 U.S. dollars is strongly correlated with increased GVC integration (figure S1).³²

³¹ This special focus was prepared by Claire H. Hollweg with valuable inputs from Marong Chea, Rounsarith Phim, Karlygash Dairabayeva, Alberto Portugal, and Miguel Eduardo Sánchez Martín. The author thanks Aaditya Mattoo, Deepak Mishra, and Sodeth Ly for thoughtful suggestions.

³² The correlation coefficient between GDP per capita and backward participation is 0.95 and forward participation is 0.97.

Box S1.

What is a global value chain?

A global value chain (GVC) refers to the series of stages required to produce a good or service that is sold to consumers, with each stage adding value and with at least two stages conducted in different countries. GVCs account for around half of world trade today.

Firms within countries participate in GVCs in two ways: (1) by importing foreign inputs for processing and further export, referred to as “backward participation”; and (2) by exporting inputs that are incorporated in the exports of other countries, referred to as “forward participation.”

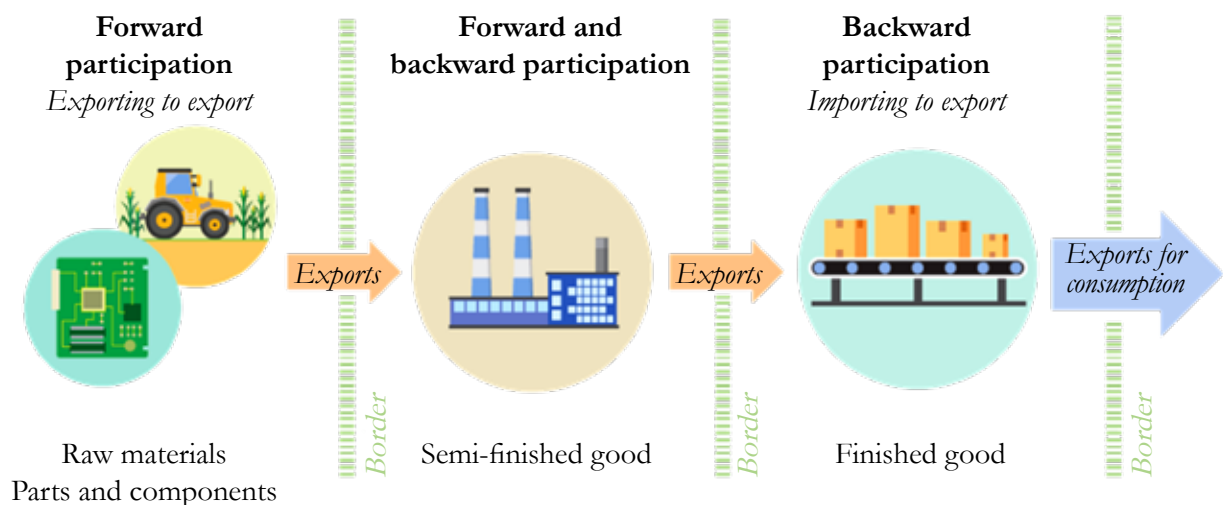
GVC participation is measured at the country or sectoral level. Backward participation is traditionally measured as the foreign value added embodied in a country’s or sector’s gross exports. Forward participation is traditionally measured as the domestic value added of a country or sector

embodied in third countries’ exports. Using firm-level data, GVC participation is proxied by firms that both export and import.

Two features distinguish GVC trade from traditional trade. First, countries import not only for domestic consumption, but also for export production. As such, GVCs involve hyperspecialization. Countries do not need to produce a whole good, they can focus on one part of that good.

Second, in contrast to “standard” trade carried out in anonymous markets, GVC transactions typically involve longer-term firm-to-firm relationships. Participants often make relationship-specific investments, such as purchasing specialized equipment and inputs or customizing intermediate products (see figure B.S.1).

Figure B.S.1: Firms within countries participate in GVCs in different ways



Source: World Bank 2019a.

GVC participation also supported productivity improvements and employment growth in Cambodia. In Cambodia, firms that both export and import—a proxy for GVC participation—are more productive and achieve higher employment growth than other firms (figure S3).³³ Using the World Bank's enterprise survey data, manufacturing firms that export and import are 26 percent more productive than firms that neither export nor import and experience 29 percent faster employment growth, consistent with international experience. One-way traders in manufacturing that export only or import only are slightly less productive and grow more slowly than non-trading firms, an anomaly in Cambodia compared to what is observed globally.³⁴

The two distinctive features of GVCs—hyperspecialization and firm-to-firm relationships—make them particularly conducive to growth and productivity improvements, for two reasons. First, because of hyperspecialization, exporting no longer requires mastering the entire production

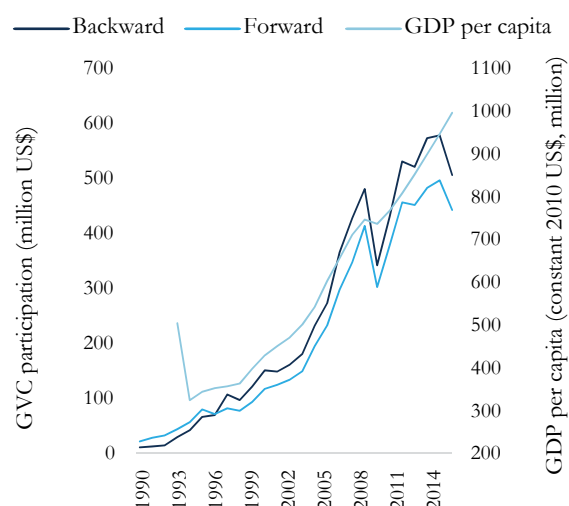
process of a good; countries can specialize in only a few tasks of the international production process. By allowing countries to specialize, GVCs make participation in trade easier and allow countries to better exploit comparative advantage.

Second, firm-to-firm relationships also make GVCs a mechanism for learning and technology transfer. In GVCs, domestic firms become interdependent with foreign firms that share know-how and technology with their buyers and suppliers. Firms have a shared interest in specializing in specific tasks, exchanging technology, and learning from each other (World Bank 2019a). For these two important reasons, firms in developing countries that participate in GVCs tend to be more productive.

In Cambodia, for example, two-way traders have a higher incidence of providing training to workers than non-traders.³⁵ Using the World Bank's enterprise survey data, manufacturing firms that export and import are 25 percent more

Figure S1: Cambodia's participation in GVCs has grown steadily since the 1990s, alongside strong GDP growth

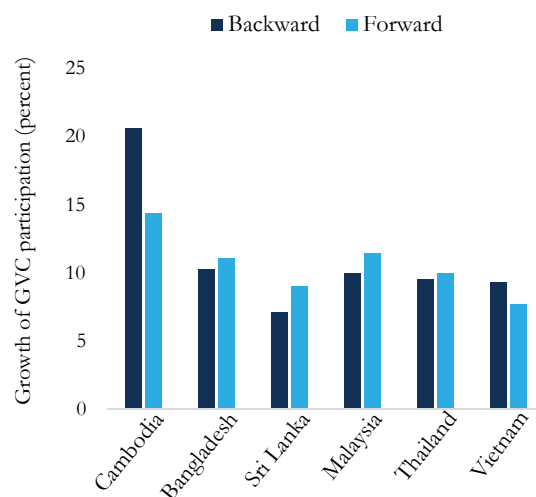
Level of backward GVC participation (foreign value added in exports) and forward participation (domestic value added in third countries' exports) from 1990 to 2015 (left axis) against GDP per capita (in constant 2010 US\$) from 1993 to 2015 (right axis)



Source: Author's calculations using data from EORA and WDI.

Figure S2: Cambodia integrated into GVCs much faster than other countries

Compounded average annual growth rate of backward GVC participation (foreign value added in exports) and forward participation (domestic value added in third countries' exports) from 1990 to 2015



Source: Author's calculations using data from EORA.

³³ Firm-level data can identify the set of firms in a country that participate in trade, further distinguishing between firms that export, firms that import, and firms that both export and import. When a given firm in a country both imports and exports, it is likely the firm participates in GVCs (World Bank 2019a).

³⁴ This result may be driven by the subsectoral composition of firms that only import or only export within the manufacturing sector, or domestic factors that prevent resource allocation to the most productive firms. Further productivity analysis is needed.

³⁵ Foreign firms are also more likely to provide training. A 2012 Employer Skills Needs Survey undertaken by the International Labor Organization and the National Employment Agency has information on training by ownership (foreign, Cambodian). Nearly three-quarters of foreign firms provide training to workers, compared to 57 percent of domestic firms.

likely to have formal training programs for their permanent, full-time employees. One-way traders in manufacturing that are either exporters or importers are less likely than non-traders to have formal training programs.

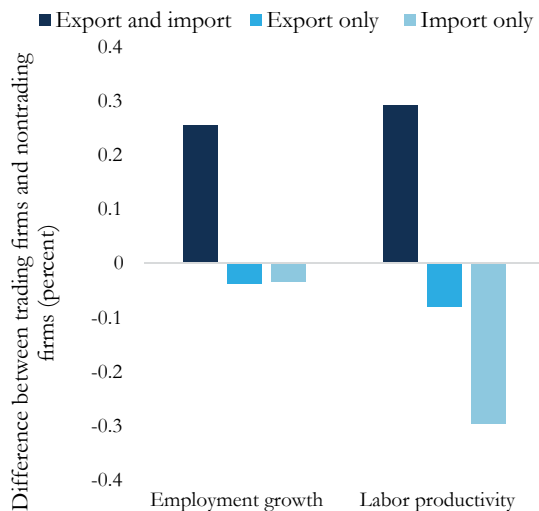
GVCs are also associated with structural transformation in developing countries, drawing people out of less productive activities and into more productive manufacturing and services activities. Firms in GVCs tend to be more capital-intensive than other (especially non-trading) firms, and so their production is less job intensive. However, the enhanced productivity leads to an expansion in firm output and thus to increases in firm employment (World Bank 2019a). Wage and salaried workers as a share of total employment in Cambodia was 49 percent in 2018, up from

14 percent in 1991 (figure S4). The garment and footwear sector alone employs more than 660,000 workers in Cambodia.

As *the World Development Report 2020* and international experience shows, GVCs can improve other development outcomes, such as lowering poverty. GVC participation is associated with poverty reduction through income and employment growth. In municipalities in Mexico, for example, the expanded presence of GVC firms is more strongly associated with poverty reduction than the presence of firms that export only or import only (World Bank 2019a). In Vietnam, poverty reduction was similarly greater in locations with a higher presence of GVC firms (World Bank 2019a).³⁶

Figure S3: Like global experiences, manufacturing firms that both import and export and more productive and grow faster

Percentage difference in employment growth and labor productivity between non-trading firms and (1) firms that both export and import or (2) firms that only export or (3) firms that only import in the manufacturing sector

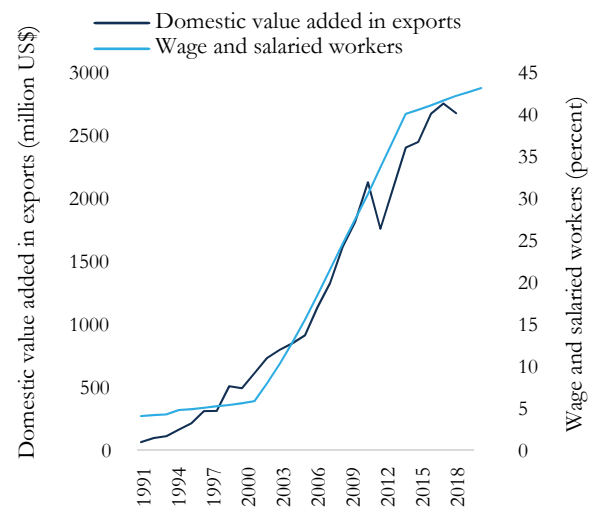


Source: Author's calculations using data from World Bank Enterprise Surveys for Cambodia in 2007, 2013 and 2016.

Note: The results are obtained by regressing firm employment growth (number of full-time workers) or firm labor productivity (log sales per worker) on dummy variables marking the type of firm (import and export, export only, import only), controlling for year fixed effects. All coefficient estimates are statistically significant.

Figure S4: Employment is increasingly in wage and salaried jobs

Level of domestic value added in Cambodia's exports from 1990 to 2015, as well as wage and salary workers as a percent of total employment



Source: Author's calculations using data from EORA and WDI.

Note: Modeled ILO estimate.

³⁶ Data do not exist to replicate this exercise for Cambodia.

GVCs are also associated with better job opportunities for women, and the broader development benefits that these opportunities bring, such as more schooling and delayed marriage and childbirth, as was the case in Bangladesh (Heath and Mobarak 2015). Worldwide, GVC firms that both import and export tend to employ more women than non-GVC firms (World Bank 2019a). Data from Cambodia's Ministry of Commerce show that there were 83 operating footwear factories in Cambodia at the end of 2018 employing around 112,589 workers, of which 87 percent are women.

3. Little progression

Cambodia rapidly engaged in limited manufacturing tasks...

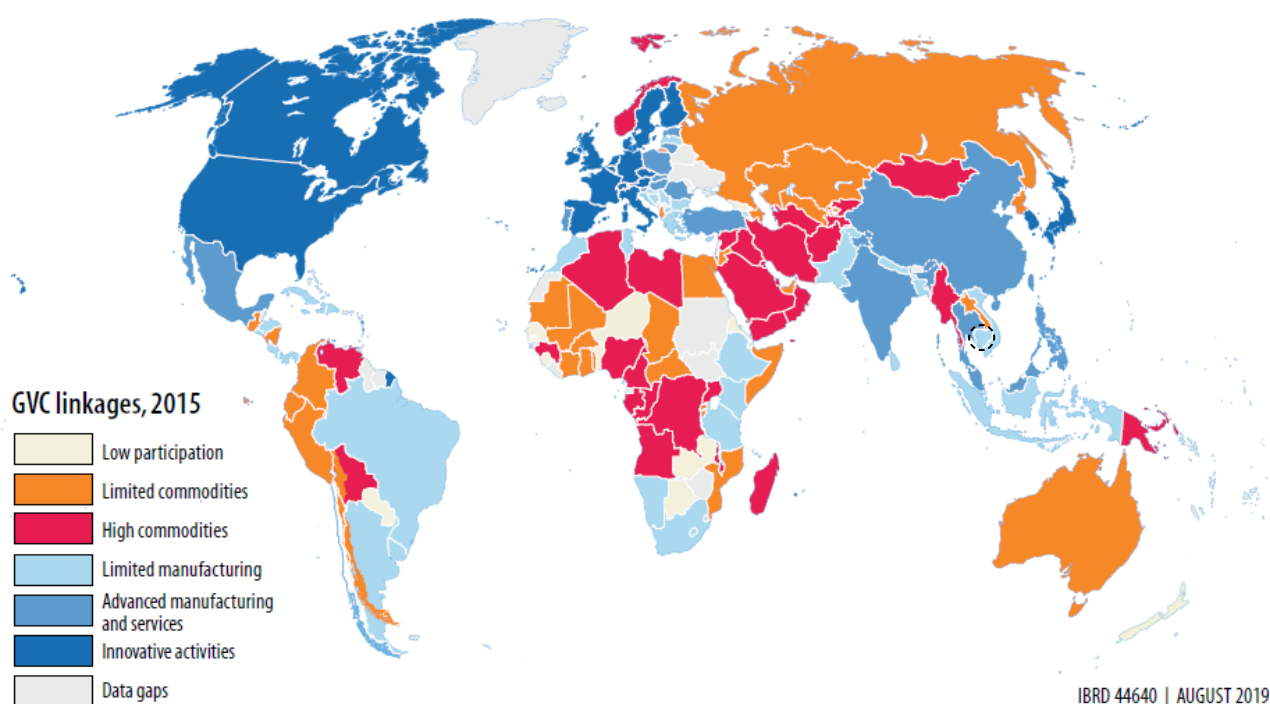
Countries around the world participate in GVCs, but how countries participate differs (figure S5). Some countries such as Venezuela and Algeria engage at the base of value chains, selling predominantly unprocessed commodities and agricultural products to trade partners. Bangladesh, Costa Rica, Ethiopia, Sri Lanka, and Vietnam, among others, are mostly engaged in simple

manufacturing tasks. Malaysia, the Philippines, Poland, and Thailand specialize in more complex manufacturing segments of the value chain or in services tasks that have become increasingly traded. And mostly advanced countries and some emerging countries such as the Czech Republic specialize mostly in innovation-intensive goods and tasks.

A taxonomy of GVC participation highlights Cambodia's specialization in limited manufacturing value chains (figure S5). The taxonomy, developed in the *World Development Report 2020*, classifies countries based on (a) the goods and services exported, (b) the extent of GVC participation, and (c) measures of innovation. The arrival of the export-oriented garment and footwear industry into Cambodia in the mid-1990s transitioned the country from specializing primarily in commodities exports to developing GVC links in simple manufacturing tasks. Cambodia's position in the value chain—primarily in assembly—increased the share of manufacturing in total domestic value added in exports, with high backward integration (imports of inputs), and limited innovation activities.

Figure S5: All countries participate in GVCs, but not in the same way

Taxonomy of GVC participation



Source: World Bank 2019a.

Note: The type of a country's GVC links is based on (a) the goods and services exported, (b) the extent of GVC participation, and (c) measures of innovation. See World Bank (2019a) for details.

Because countries participate differently in GVCs, the consequences of participation are also different. To maximize the benefits, countries need to move to the next stage of participation.

...with little diversifying or upgrading since

While Cambodia has seen rapid growth in limited manufacturing GVCs for many years, particularly garments and footwear, the country has not yet transitioned to the next stage of GVC participation of advanced manufacturing and services. Examples of such stages of participation are motor vehicles parts and components, electronics assembly, medical devices manufacturing, and the services segments of value chains such as design or marketing and branding. Instead, there has been

little diversification into other value chains, but also little upgrading within existing value chains.

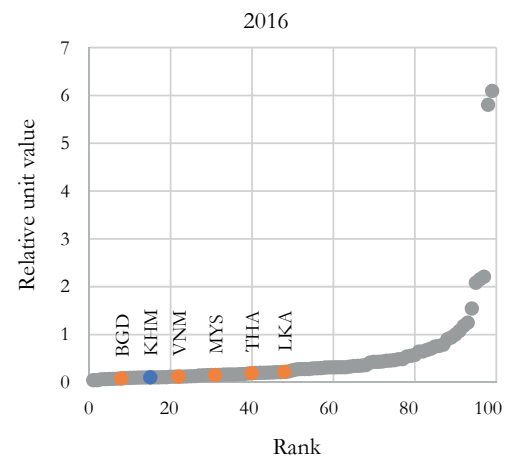
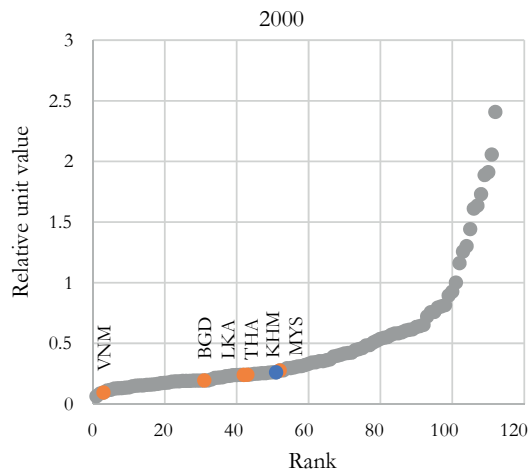
First, there has been limited upgrading to higher value-added products or tasks within garments over the past 20 years. The composition of top garment products in Cambodia has not changed significantly; four of the top five garment products in 2017 were also the top five garment products in 2000.³⁷

Cambodia's top export garment products (hs6=611020 and hs6=611030) are also on the lower end of the quality ladder globally (figure S6). Cambodia's unit value for knit or crocheted sweaters, pullovers, and vests (hs6=611030) ranked 15th of 99 countries exporting that product to the

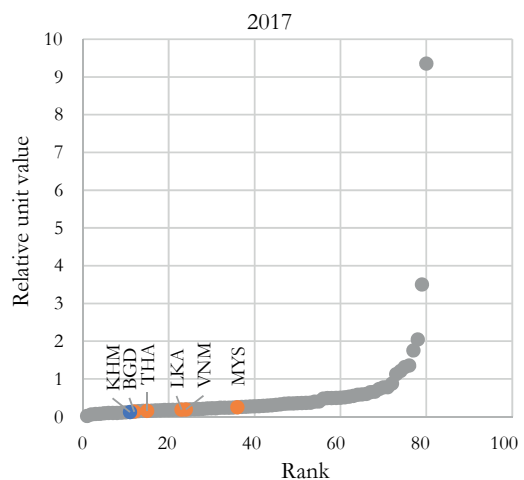
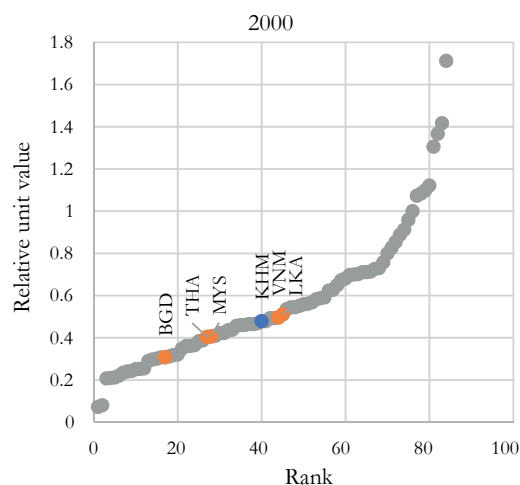
Figure S6: Within garments, there has been little *upgrading* within products between 2000 and 2016/2017

The relative unit value of a product for each year and exporting country

Exports of knit or crocheted sweaters, pullovers, or vests (hs6=611030) to the United States



Exports of cotton sweaters, pullovers, or vests (hs6=611020) to the UK



Source: Author's calculations using data from Centre d'Études Prospectives et d'Informations Internationales (CEPII).

Note: For each product, year, and importing country (the United States and the UK), the relative unit value is calculated as the exporting country's unit value relative to the unit value at the 90th percentile of the unit value distribution across countries that export that product to the importing country. BGD = Bangladesh; KHM = Cambodia; LKA = Sri Lanka; THA = Thailand; VNM = Vietnam.

³⁷ There has been some diversification within garments, where the top five garment products exported in 1997 represented 57 percent of total garment exports, declining to 36 percent in 2017.

United States in 2016, and 11th of 80 countries exporting cotton sweaters, pullovers, and vests (hs6=611020) to the UK market in 2017.

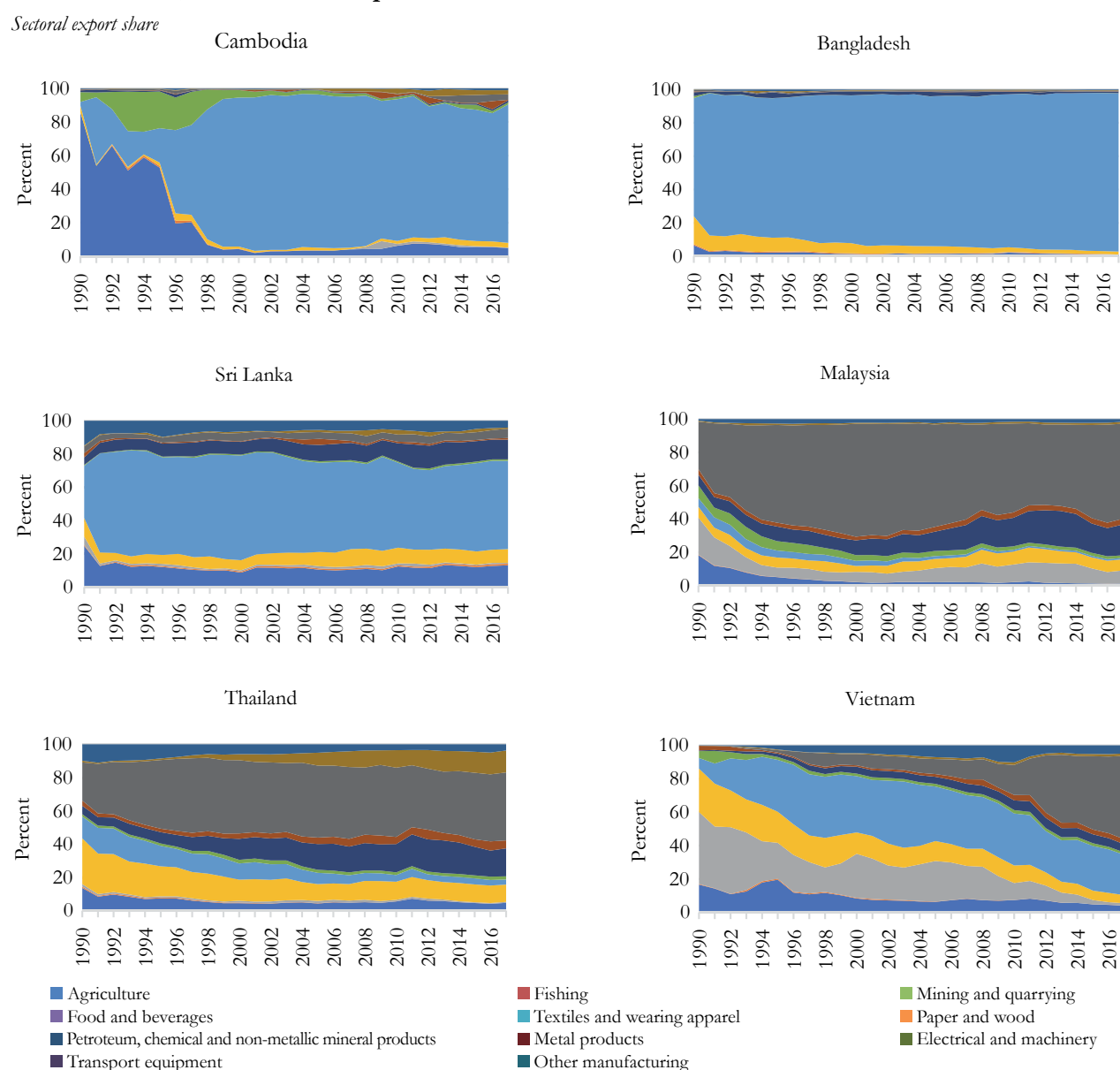
More striking is that comparator countries including Vietnam experienced a significant increase in their relative unit values between 2000 and 2016, moving up the quality ladder, while Cambodia has fallen behind globally. For knit or crocheted sweaters, pullovers, and vests (hs6=611030) to the U.S. market, Vietnam improved in relative unit value rank from 3rd to 22nd between 2000 and 2016, while Cambodia fell from 51st to 15th. A number of factors explain Cambodia's performance in the sector, and the challenges the country faces for

upgrading (see box S2).

Second, there has been little diversification into other GVC sectors outside of garments and footwear (figure S7). The garment and footwear sector remains the largest exporting sector of Cambodia's economy, representing about 70 percent of total merchandise exports.

Transitioning to advanced manufacturing and services GVCs presents a much bigger challenge for countries, an experience not unique to Cambodia. Like Cambodia, the composition of Bangladesh's and Sri Lanka's merchandise exports has changed little since the arrival of garments and footwear. The factors that make

Figure S7: Cambodia's participation has been concentrated in garments, but little *diversification* since then, unlike other comparator countries



Source: Author's calculations using data from UN Comtrade (mirror data).

Box S2.

Cambodia in the garment, footwear and travel goods global value chain

The garment and footwear sector grew sharply over the past two decades to become the Cambodian economy's largest export earner. Exports grew from US\$80 million in 1996 to more than US\$9.5 billion in 2018, and the sector now employs more than 660,000 workers. Footwear products specifically are growing remarkably. Cambodia was among the top 10 footwear producers, exporting footwear products at a value of US\$1,041 million in 2018. Key questions emerging from this impressive performance are what are the key factors behind the success of the garments and footwear sector in Cambodia in the past two decades, and what are the main challenges confronting the sector to move up the value chain.

Analytical work conducted by the World Bank in 2015 identified three key reasons to motivate investors to invest in the garment and footwear sector: (1) competitive labor costs; (2) market access to international markets, such as the EU through EBA; and (3) tax incentives provided by the government to garment producers in the form of qualified investment projects. To some extent, these factors were the key competitive advantages to compete with other players in the sector, such as Bangladesh, Myanmar, and Vietnam. In addition, the comparative advantages that enable Cambodia to compete with larger garment producers include the high level of investment and trade openness; liberal economic policies; and macroeconomic, political, and social stability.

Despite its strengths, the garment and footwear sector faces key challenges that could hinder further developments of the sector, in particular for it to move up the value chain. These challenges include lower productivity, higher electricity and logistics costs, unofficial fees, and low backward links. The combination of these factors results in high cost of doing business in the sector making it less competitive and creates a barrier to diversifying into similar productions and producing higher value-added products.

Many factory managers operating in multiple countries in recent years say that the level of productivity of Cambodian workers is lower than that of workers in Vietnam—by around 20 percent—and the productivity of garment factories in China is 20 to 30 percent higher than in garment factories in Vietnam. Key factors causing this are the low level of basic education of workers in Cambodia and the limited quality of general education to produce a skilled labor force, and low enrollment in the Technical and Vocational Education and Training Centers.

The high cost of electricity is also a major issue facing

garment and footwear operations in the country. A study conducted by the International Labor Organization (ILO) in 2016 found that electricity costs more than twice as much in Cambodia than in Vietnam and Thailand despite recent cost reductions. The cost of electricity in Cambodia for industrial and commercial enterprises is US\$0.13 to US\$0.17 per kilowatt hour compared to around US\$0.04 to US\$0.09 in Thailand and Vietnam. However, electricity costs have fallen slightly in recent years, and there are signs that the price of electricity may be further cut in Cambodia. During the Government Private Sector Forum, the government initiated measures to reduce the price of electricity and outlined reduced electricity price targets in the Industrial Development Policy 2015–2025.

Cambodia's performance in logistics is uncompetitive compared to neighboring Thailand and Vietnam. Logistics costs remain high due to poor quality of logistics services and inadequate quality of the transport infrastructure. The cost and time to export a container from Sihanoukville, Cambodia's major seaport, is much higher than the global average, as reflected in the country's poor ranking in the Trading Across Borders indicators of Doing Business (108th out of 190 countries). Transport and warehousing costs in Cambodia are higher than in Thailand and Vietnam. This means that reducing logistics cost in Cambodia is not just an issue of cutting transport cost. The high cost of inventory is a by-product of the unreliability of Cambodia's logistics system.

Not much progress has been made to improve backward links by connecting FDI firms with domestic suppliers. More than half of all FDI firms surveyed were keen to increase local sourcing, but often had not found competitive suppliers to buy from. The main reason behind this are, as reported by FDI firms, is a lack of competitive local entrepreneurs active in FDI-dominant sectors. Supporting industries for light manufacturing are also missing. The cumbersome process for receiving value-added tax (VAT) refunds for locally sourced purchases was also highlighted as a critical barrier. In addition, the supply chains of the garment sector are primarily controlled by international buyers and the headquarters of garment factories. Furthermore, domestic suppliers are often unable to comply with FDI criteria related to quality, cost, and delivery (QCD) of inputs. Relatively few businesses hold internationally recognized quality certifications, and there are few business development services (public or private) available to provide support.

The analysis of key strengths and weaknesses also suggests that Cambodia's competitive advantages have been eroding in recent years due to both internal and external factors. First, the cost of labor is increasing yearly, which must be compensated for with higher productivity and reduction in other operating costs. The minimum wage for the garment and footwear sector increased from US\$128 in 2015 to US\$190 in 2020. Second, the EU has started a process that might lead to the withdrawal of Cambodia's duty-free and quota-free access to the EU Single Market under the EBA scheme in 2020. Third, a higher level of workforce skills and investment in machinery and business processes to compete on quality are needed for the emerging travel goods industry, which is viewed as a relatively high-value industry compared to other industry segments, such as cut-make-trim garment operations. Fourth, Vietnam and the EU reached a free trade deal agreement in October 2018 after three years of negotiations. The new EU-Vietnam Free Trade Agreement, when effective, will eliminate more than 99 percent of all tariffs, the most salient of which, with respect to Cambodia, will be the removal of duties on all textile fabric trade between Vietnam and the EU. These duties are currently set at 12 percent. The agreement was signed on June 30, 2019. However, a comprehensive impact assessment is needed to understand the negative and positive impacts of this trade agreement on the garment and footwear sector in Cambodia.

The Royal Government of Cambodia recently launched several initiatives to improve the country's competitiveness. While these initiatives are welcome measures, only time will tell whether they are successful. These initiatives include (1) creation of the state-owned Small and Medium Enterprise Bank of Cambodia (SME Bank), which will increase access to finance for Cambodian SMEs capitalized with US\$100 million; (2) creation of the Entrepreneurship Development Fund, which will support the Entrepreneurship Promotion Center and promote the capacity of high-potential SMEs with a US\$5 million annual fund; (3) creation of a Skills Development Fund to promote skills training; and (4) SME tax incentives consisting of profit tax exemptions and special deductibles for SMEs in prioritized sectors.

Several reform measures were also introduced during the Government-Private Sector Forum on March 29, 2019, as part of trade facilitation and improving the competitiveness of the country. These reform measures include (1)

removing CamControl from border checkpoints; (2) removing KAMSAB (Kampuchea Shipping Agency and Brokers) officers from ports; (3) canceling Certificates of Origin (COs) for destinations not required; (4) reducing logistic cost, port charges, and handling fees (lift-on/lift-off, LOLO); (5) reducing electricity costs; (6) reducing the number of public holidays; (7) streamlining factory inspection procedures; and (8) railway development. If implemented strictly and effectively, these reforms will undoubtedly increase the competitiveness of the country and reduce the cost of doing business, but it will take time for business communities to realize the benefits.

Going forward, several measures can be taken to mitigate risks and promote this important sector into the next phase of development. These policy measures and action plans should include (1) fast-tracking implementation of new government initiatives to improve the investment climate and monitoring the effectiveness of government policy measures introduced during the Government-Private Sector Forum to reduce the cost of doing business; (2) continuing to maintain and improve the business enabling environment, and the stability and predictability of both the political and social environment while enhancing and improving production capabilities, access to international markets aimed at moving up the value chain, and encouraging product diversification; (3) strengthening the absorptive capacity supported by the entire system of institutions, support infrastructure, and the policy environment that promotes learning and innovation, and facilitating the needed change toward a more proactive and competitive mindset and business culture by entrepreneurs and the workforce; (4) improving logistics performance through lowering logistics costs, increasing service reliability, reducing delays, and speeding up efforts to establish a modern and efficient logistics/multimodal transport system that will improve logistics services, reduce costs, increase reliability, and decrease the time needed to move goods within Cambodia and across borders; and (5) intensifying efforts to promote FDI links with domestic firms to foster GVC integration and transformation of the production base by designing a comprehensive FDI linkages action plan and considering establishment of demand-driven supplier development programs to upgrade the capacity of Cambodian firms in line with international market demand.

Note: This box was prepared by Marong Chea based on several ILO "Cambodia Garment and Footwear Sector Bulletins" and various research reports.

GVCs a particularly strong vehicle for technology transfer, such as interdependence of firm-to-firm relationships and knowledge asymmetries along the value chain, can also make it particularly difficult for upgrading (World Bank 2019a). In some countries and sectors, firms could be stuck in dead-end tasks with few opportunities to innovate, upgrade, and diversify. The wrong skills mix of the domestic workforce, the organization and governance of some value chains, and the nature of certain technologies may not favor the process of learning and innovation typical of relational GVCs.

Yet other countries in the region have seen more progression than Cambodia. Thailand and Malaysia, for example, have diversified sectors and transitioned into advanced manufacturing GVCs (figures S5 and S7). Vietnam has also been outperforming Cambodia since the beginning of this decade, driven by successful integration into the electronics GVC, something that Cambodia has not yet achieved. While garments are also a key export sector for Vietnam, which from the beginning enjoyed a broader production base and a more diversified export basket, the country has also been able to deepen its integration in the electronics global value chain. In particular, since the beginning of the operation of a massive Samsung factory in 2012, Vietnam has attracted a horde of international and national suppliers, giving way to an established industrial cluster. An abundant and relatively well-skilled labor force and the role of the state in supporting worker recruitment and training, as well as needed fixes in the business environment, are often cited as the reasons why Vietnam succeeded in attracting the Korean multinational (Sturgeon and Zylberberg 2017).

Cambodia's prospects for diversification and upgrading look more challenging. Despite impressive growth performance in recent decades, Cambodia's exports remained heavily dependent on EU (39 percent) and U.S. (31 percent) markets in 2018, making the sector vulnerable to the external environment, for instance, the possible withdrawal of Everything But Arms (EBA) trade preferential treatment. In 2018, the EU initiated the process toward suspending Cambodia's access

under the EBA, putting further pressure on established exporters. It is also observed that the UK market represents a significant market share in the EU market for garments and footwear. Cambodia exported 1.0 billion (10.6 percent of total garment and footwear exports) to the UK market alone in 2018. Therefore, changes in UK market conditions, such as a disorderly Brexit, could also have significant implications for the garment and footwear sector. While Cambodia has been able to attract a few pioneer producers of bicycles, electrical appliances (Minibea), and auto parts (Denso, Sumi Wiring System), it has so far been unable to form industrial clusters in these value chains, and export diversification remains limited. Furthermore, there are signs that FDI into the manufacturing sector has slowed significantly in recent years.

One notable exception is the recent diversification into travel goods exports of Cambodia, such as handbags and suitcases, which is growing quickly from a low base. Cambodia is enjoying preferential access to the U.S. travel goods market under its General System of Preferences, which has granted Cambodia tariff-free access for travel goods exports since July 1, 2016. The removal of U.S. customs tariffs on Cambodian-made travel products such as suitcases, handbags, wallets, vanities, and similar products is widely believed to be an important trade policy to help boost Cambodia's travel goods export-oriented industry. Cambodia exported travel goods worth just under US\$400 million to the United States in 2018, up from about US\$50 million in 2016. The travel goods and handbags sector is thus offering significant scope for growth.

4. Moving to the next stage of participation

Economic fundamentals and policy choices determine participation

Economic fundamentals—such as factor endowments, market size, geography, and institutions—determine GVC participation (World Bank 2019a). Econometric analysis undertaken for *the World Development Report 2020* shows that a multitude of factors are correlated with participation globally (figure S8). Some factors

are more important for forward or for backward participation. For example, countries with higher endowments of natural resources are more likely to have higher forward participation, because they sell raw materials used in the production of intermediate inputs. Countries with lower labor costs are more likely to have higher backward participation, because they import foreign inputs for assembly and export final products.

Extending the econometric analysis to include country-specific factors confirms that the cross-country regression results also hold for Cambodia.³⁸ Given Cambodia's current performance with respect to determinants, Cambodia overperforms globally with respect to its backward participation (use of foreign inputs for export), similar to other regional countries such as Malaysia, Thailand, and Vietnam. At the same time, Cambodia significantly underperforms in forward participation (supplying inputs for further export) globally and relative to all comparator countries.

But policy choices that shape these economic fundamentals also matter (World Bank 2019a). For example, FDI is a key determinant of both forward and backward participation, and the right business environment matters for attracting FDI. Improved connectivity overcomes geographic barriers such as remoteness from major GVC

hubs such as the United States, the EU, and China. Trade liberalization that improves access to foreign inputs and entry into trade agreements that improves access to foreign markets can promote both backward and forward participation.

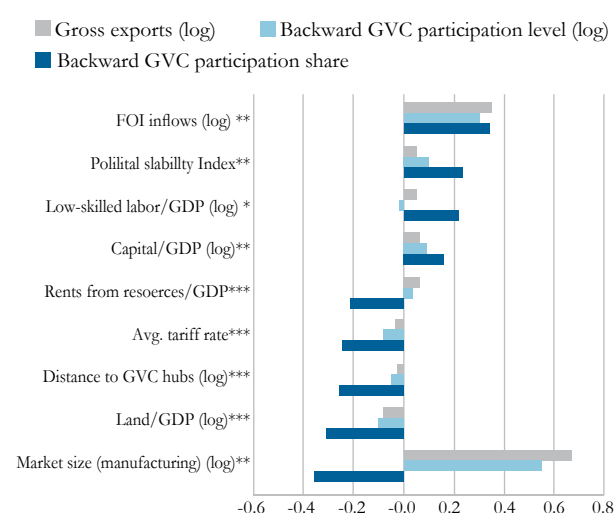
More sophisticated policies support more sophisticated participation

Global experience shows that transitioning to limited manufacturing GVCs from primary product specialization typically requires FDI, competitive labor costs, addressing business climate constraints, assuring basic political stability and rule of law, and timely access to imported inputs. Cambodia's transition from commodities to limited manufacturing GVCs has similarly been driven by this basic policy mix.

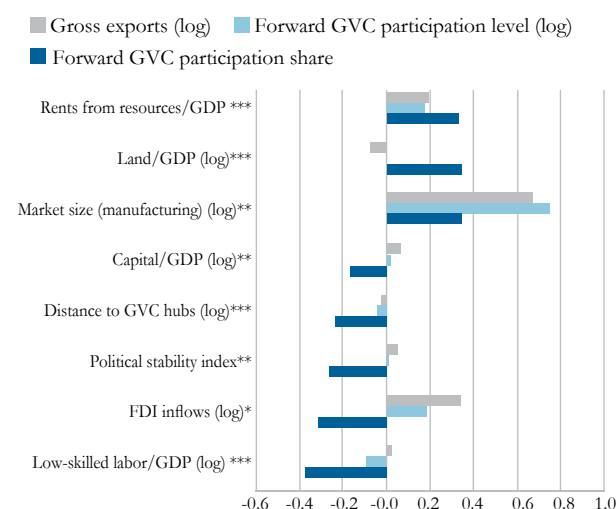
In Cambodia, FDI inflows, a large pool of low-skill and low-wage labor, and preferential access to key exports markets were behind Cambodia's rapid integration into limited manufacturing GVCs. While higher capital endowments stimulate GVC participation, for countries relatively scarce in capital, FDI can provide foreign capital as well as know-how to successfully participate. In Cambodia, FDI inflows have been high and sustained over many years. Since 1993, Cambodia's average FDI net inflows have averaged 7.8 percent of GDP,

Figure S8: Factors that determine participation globally also hold for Cambodia

Backward participation



Forward participation



Sources: World Bank 2019a; Fernandes, Kee, and Winkler 2019.

Note: The graphs show standardized beta coefficients for each variable on the y-axis from three separate regressions using gross exports, backward GVC participation (levels and shares, left figure), and forward GVC participation (levels and shares, right figure) as dependent variables. The determinants are measured as averages in the previous decade.

³⁸ Specifically, a Cambodia interaction term is included in separate cross-country regressions. The interaction was not statistically significant, suggesting that the Cambodia-specific relationship is not different from the global relationship.

higher than Vietnam's (6.2 percent) and other countries like Bangladesh (0.7 percent), Sri Lanka (1.3 percent), Malaysia (3.8 percent), and Thailand (2.8 percent). Key policy reforms for Cambodia in these areas have included an open FDI policy and improved trade facilitation. According to the World Bank's Doing Business, the time (days) to export declined from 43 in 2006 to 22 in 2015, while the time to import fell from 54 to 24.³⁹ Since 2015, time to import and export (border and document compliance in hours) have not changed.

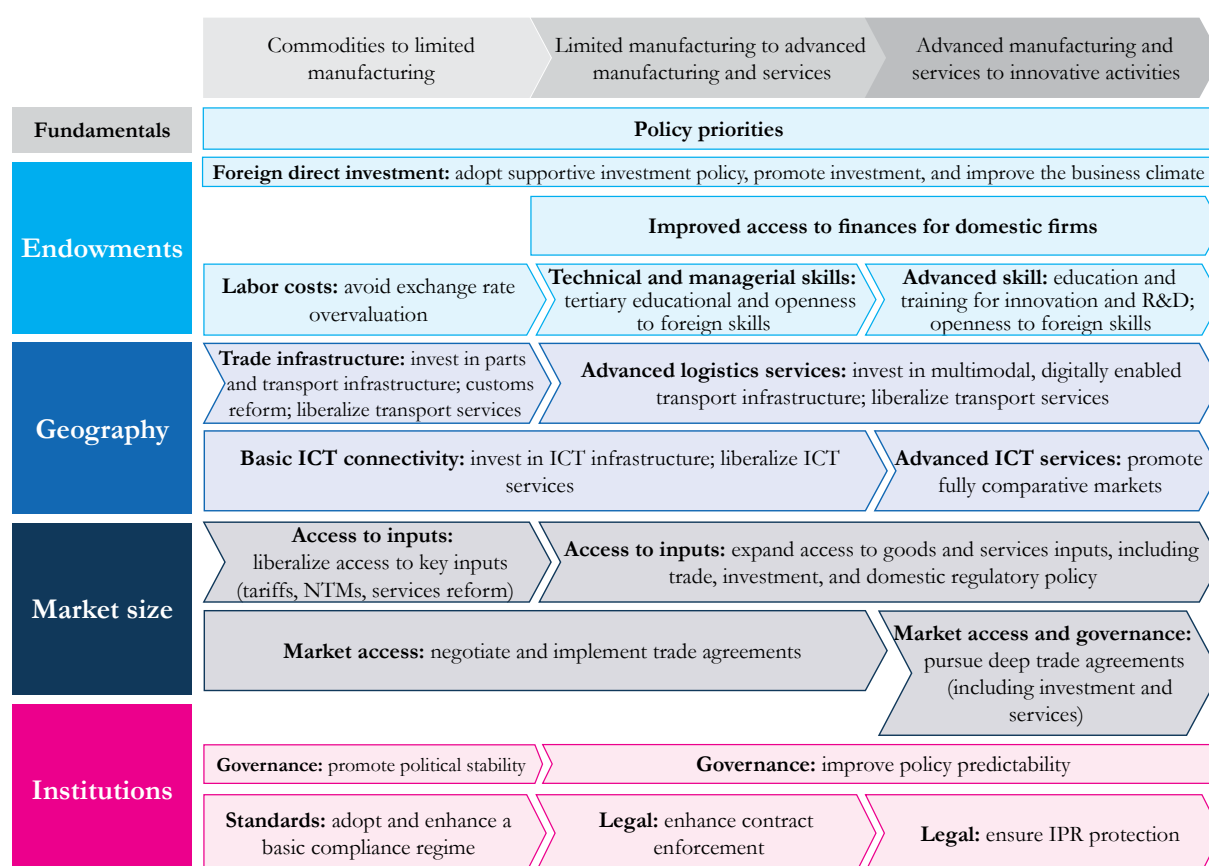
Labor costs until recently have been relatively lower in Cambodia. The minimum wage in the garment sector was around US\$80 a month in 2013. The country's minimum wage legislation has been in effect since 1997, when the regular minimum wage was set at US\$40, and has been revised multiple times since then. In recent years, the minimum wage in the garment industry has been increasing rapidly, which has led to an overall increase in wages

in garment firms. (World Bank 2019c). By 2019, the minimum wage had increased to US\$182 a month.⁴⁰ In Vietnam, the minimum wage ranged from the equivalent of US\$126 to US\$180 per month in 2019,⁴¹ while garment workers in Bangladesh earn approximately the equivalent of US\$95 a month.⁴²

But the policies that have supported Cambodia's entry into limited manufacturing will likely not be those that support Cambodia's upgrading; a much more sophisticated policy mix is needed. Transitioning from limited manufacturing to advanced manufacturing and services—the next stage of participation—presents a much bigger challenge than basic manufacturing (figure S9).

While FDI and market access remain important, these advanced manufacturing GVCs typically require a more educated workforce and improvements in managerial practices and technical skills. Improved access to finance for domestic

Figure S9: Policies support transitioning to more sophisticated participation in GVCs



Source: World Bank 2019a.

³⁹ The Doing Business methodology changed in 2015.

⁴⁰ Unlike many countries in the region, the Cambodian economy is highly dollarized, and employees are paid in U.S. dollars.

⁴¹ <https://www.vietnam-briefing.com/news/vietnam-hikes-minimum-wages-by-5-3-percent-in-2019.html/>.

⁴² <https://fashionunited.uk/news/business/bangladesh-raises-minimum-wage-for-garment-workers/2018091438912>.

firms, more advanced logistics, competitive energy costs, access to more sophisticated services inputs, and enhanced contract enforcement are needed for these advanced manufacturing and services sectors. Policy predictability, in addition to macroeconomic stability, becomes an increasingly important dimension of governance.

Deep trade agreements help

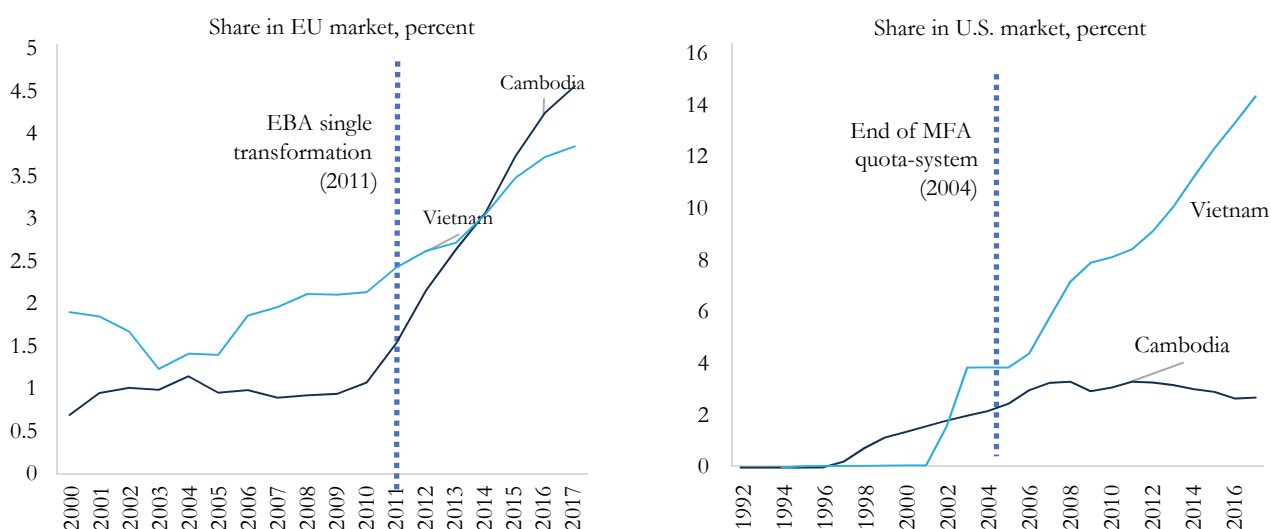
Market access through trade preferences has been a key determinant of Cambodia's participation. As in many other countries, during the first stage of GVC development, the granting of preferential trade access to key markets coupled with low labor costs contributed to the arrival of the export-oriented garment and footwear industry. In Cambodia, joining the General System of Preferences in 1997 supported the arrival of Taiwanese and Chinese producers and kick-started garment exports to the United States under the Multifiber Agreement (MFA). While Cambodia's share of garments in the U.S. market plateaued once the quota-system under MFA ended at end-2004, garment exports to the EU surged since. In 2011, the rules of origin under the Everything But Arms arrangement shifted from double (yarn→textiles→apparel) to single (textiles→apparel) transformation requirement. The recent surge in travel goods exports similarly

is related to the granting of the General System of Preferences of the United States to drive this transition. In Vietnam's case, the U.S.-Vietnam Bilateral Trade Agreement of 2001 resulted in a boom in the exports of garments (and other products) to the United States (figure S10). While surpassed by Cambodia (which benefits from EBA) in 2014, Vietnam's garment export share in the EU market has not stopped growing and could receive a further boost when the free trade agreement with the EU goes into effect.

One question is how a potential loss of preferences, and increased trade protectionism globally, will impact GVC trade. Recent World Bank estimates suggest that the loss of EBA preferences could result in a decline of Cambodia's exports to the EU market of about 8.7 percent to 10.4 percent for garments, 25 percent for footwear, and 36 to 81 percent for milled rice. The total value amount is US\$513.6 million to US\$654.0 million (World Bank 2019d). Uncertainty also exists around increased protectionism by major markets. Weakening external demand combined with global trade policy uncertainty have been weighing on regional activity through declining exports, deteriorating business confidence, and weakening investment, though Cambodia currently has been less exposed than other regional countries (World Bank 2019d).

Figure S10: Trade agreements, and their rules of origin, have been important for Cambodia's GVC participation

Share of Cambodia's and Vietnam's garments exports in the U.S. and EU markets



Source: Author's calculations using data from UN Comtrade (mirror data).

As highlighted in *the World Development Report 2020*, international cooperation enables GVC-related trade growth, but particularly when this goes beyond issues of market access and national treatment, to include agreements to protect certain types of intellectual property, to adopt common approaches to regulate services sectors, or to implement a competition law that embodies criteria that mirror those of trading partners (World Bank 2019a). In fact, GVC trade is greater between countries sharing deep trading agreements (World Bank 2019a).

Own protectionism is costly

Market size also determines the level of GVC participation; countries with larger markets have a larger industrial capacity and are less likely to use imported inputs in their exports (World Bank 2019a). Countries like China, Japan, and the United States have lower backward GVC participation as a percentage of total exports. Larger market size also allows countries to achieve economies of scale and to specialize in more contiguous stages of production. Cambodia's market size, particularly in manufacturing, is smaller than peer countries, creating a natural barrier to participation (figure S11).

Trade liberalization can help expand market size and promote GVC participation by lowering the

costs of inputs. In a world of GVCs, where firms import to export, higher costs of intermediate inputs (as well as higher wages) can act as a barrier to participation. In fact, trade liberalization has a more positive effect on GVC trade than on traditional exports. Though tariffs declined following Cambodia's World Trade Organization membership, the average weighted tariff rate of manufacturing products is higher in Cambodia than comparator countries except Bangladesh (figure S12). In Cambodia, the average weighted tariff is 9.7 percent, relative to, for example, Vietnam, which is 2.6 percent.

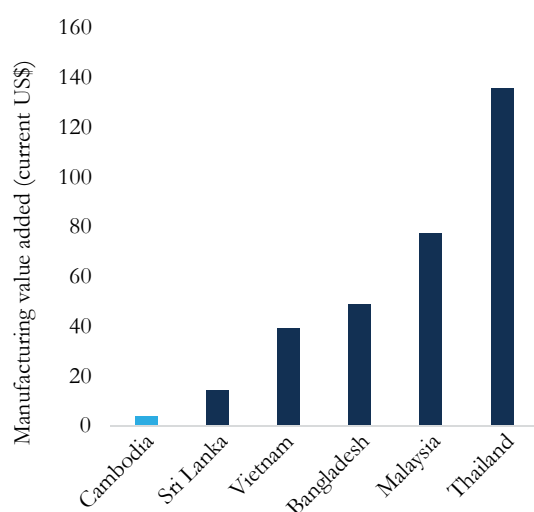
Human capital is vital

International evidence shows that investments in people are needed to drive economic progress and sustainable development. High and rising endowments of human capital, combined with high rates of physical capital investment, account for a large part of the growth successes of the East Asian miracle countries, including Malaysia and Thailand (World Bank 2018).

Human capital accumulation also enables countries' integration in more complex GVCs. While the abundant supply of low-cost labor in lower-income countries is often an entry point for participation in the labor-intensive manufacturing segments of GVCs, upgrading knowledge

Figure S11: Cambodia has a smaller market...

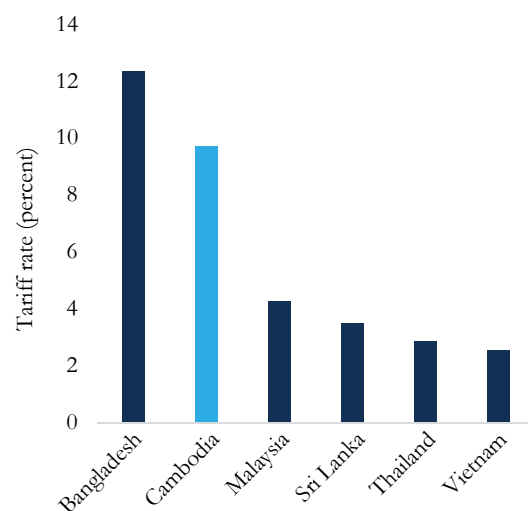
Manufacturing value added in current US\$, 2018



Source: Author's calculations using data from Penn World Tables.

Figure S12: ...but with higher barriers to imports

Weighted average tariff rate on manufacturing products in percent, 2016



Source: Author's calculations using data from World Bank World Development Indicators.

Note: Data for 2015 for Thailand and Sri Lanka.

and skills becomes necessary for transitioning into advanced manufacturing and services and innovation activities. For example, cross-country evidence supports the positive correlation between skills and integration in innovative GVCs; a relatively low endowment of low-skilled labor in the 2000s increased the probability of a country specializing in innovative activities in 2011 (World Bank 2019a).

Cambodia performs below comparator countries on human capital accumulation. Cambodia's score on the Human Capital Index (HCI) of the World Bank demonstrates gaps in health, early childhood nutrition, education, and skills that constrain the productivity of the future labor force.⁴³ Cambodia has an overall HCI value of 0.49, meaning that—based on the status of health and education outcomes—a child born today will be 49 percent as productive when she grows up as she could have been if she enjoyed complete education, good health, and a well-nourished childhood. Overall, Cambodia ranks 100th out of 157 countries on the HCI, far behind countries such as Vietnam and Thailand but ahead of neighboring Lao PDR.

Cambodia has made good progress in improving education outcomes over the past decade, with gross enrollment for primary education similar to Vietnam and Malaysia. Yet learning outcomes remain to be further improved (World Bank 2019b). Access to secondary and tertiary school remains a challenge. In 2017, gross enrollment for lower secondary was only 69 percent and upper secondary 29 percent. Gross enrollment for tertiary was the lowest of comparator countries (figure S13). Quality of schooling also places Cambodia at a disadvantage relative to middle-income countries in East Asia. While four-year-old Cambodian children today are expected to complete 9.5 years of school, in terms of quality-adjusted years of education, their learning will be equivalent to only 6.9 years because of the lower quality of the schooling they are likely to receive.

This is reflected in Cambodia's recent Programme for International Student Assessment (PISA)

scores. PISA was developed by the OECD in 1997 to evaluate 15-year-old students on reading, mathematics, and scientific proficiencies and measures their competence in real-life contexts. Since 2014, the OECD has piloted PISA for Development, which includes nine members from low- and middle-income countries, including Cambodia. Though Cambodia's score on mathematics is on par with other PISA for Development countries, student performance in reading and science is significantly below average. In Cambodia, looking at the minimum level of proficiency, only 8 percent of students achieve level 2 in reading, and 10 percent of students achieve level 2 in mathematics. Only 5 percent achieve level 2 in science.⁴⁴ But, importantly, Cambodia scores significantly below the regional average, by almost a third.

The education level of the workforce employed in the production of goods and services varies across different sectors, where some sectors employ high- or low-skilled labor more intensely. Textiles and wearing apparel—an example of limited manufacturing participation—is one of the least human capital-intensive sectors. Data for the United States show that for each worker with a college education, there are about seven workers with secondary education or lower (Annex 1, figure A1). This ratio is likely to be much larger in developing countries that specialize in low-skilled segments of the value chain. Advanced manufacturing sectors, in contrast, employ a higher proportion of more educated workers. In electrical and machinery—an example of advanced manufacturing and services participation—there are about two workers with secondary education or lower for each worker with a college education in the United States.

Because countries export different baskets of goods and services that require a different skills mix, the average human capital intensity of a country's exports also varies across countries. The revealed human capital intensity of a country's export basket is measured as the weighted average

⁴³ These investments in human capital must start early. Research shows that the first 1,000 days between conception and a child's second birthday are critical periods of physical and cognitive development. These investments in human capital must then continue into adulthood.

⁴⁴ The PISA measures proficiency along six levels, which captures students' capacity to apply knowledge and skills in real-life contexts. A level 2 proficiency is considered the "minimum level," which is in line with the sustainable development goals for education.

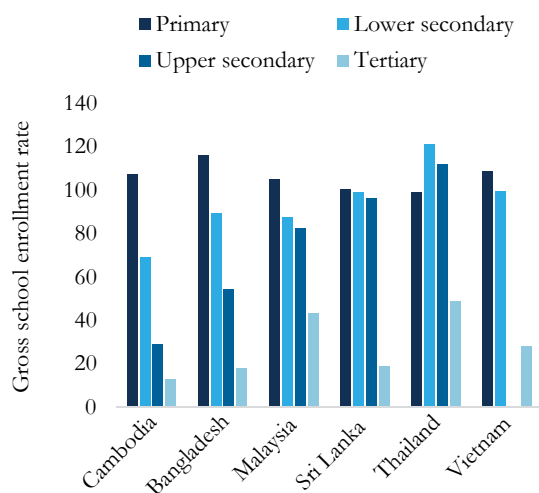
ratio of “skilled” to “unskilled” workers, where the weights represent the importance of that sector in a country’s export basket. As above, skilled is proxied by having achieved tertiary education. Malaysia, Thailand, and Vietnam, whose export baskets have diversified into sectors such as electrical and machinery, food and beverages, transport equipment, or petroleum products, which are relatively more human-capital intensive, reveal a higher skill intensity of exports. Countries like Bangladesh, Cambodia, and Sri Lanka that export largely textiles and/or wearing apparel, exhibit lower skill intensity.

And countries that are human-capital abundant tend to export products that are more human-capital intensive (figure S14). This is in line with the Stolper Samuelson theory of international trade, which suggests that a country that is relatively capital abundant will export capital-intensive goods, while a country which is relatively labor abundant will export labor-intensive goods.

Cambodia is an outlier in a few respects. First, Cambodia’s HCI is lower than both comparator countries and countries at a similar level of economic development.

Figure S13: Though having improved remarkably, Cambodia’s educational outcomes remain below comparator countries

Gross school enrollment rates, 2017



Source: Author’s calculations using data from the United Nations Conference on Trade and Development (UNCTAD).

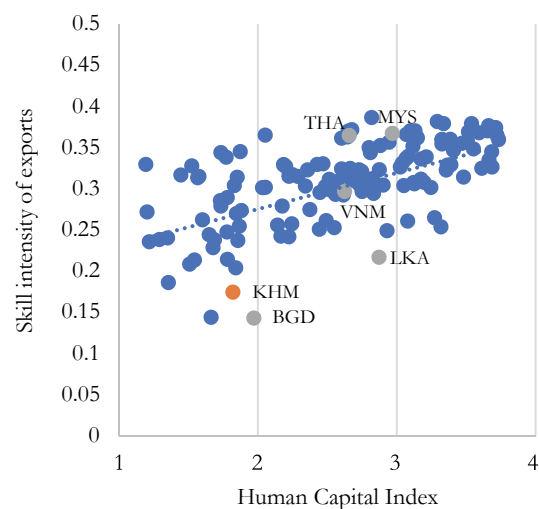
Note: Data for upper secondary for Cambodia are for 2015, data for primary for Bangladesh are for 2018, and data for tertiary for Thailand and Vietnam are for 2016.

Second, even given Cambodia’s relatively low HCI, Cambodia underperforms in terms of the skill intensity of its export basket. Malaysia, Thailand, and Vietnam—the countries that export products that are more human-capital intensive—also have higher scores on the HCI. Bangladesh and Cambodia—the countries that export products that are less human-capital intensive—have lower scores on the HCI. This finding holds across countries, where countries with higher endowments of human capital specialize in relatively more human capital-intensive export sectors (figure S14).

Third, Cambodia’s export basket not only contains products that employ fewer skilled workers than the products exported by comparator countries, but Cambodia has also seen less progression toward more skill-intensive products over the past decade than comparator countries. Malaysia, Thailand, Vietnam, and Sri Lanka have all seen improvements in the average human capital intensity of their exports—meaning that these countries’ export baskets are shifting to more skill-intensive products—while at the same time have improved their HCI (figures S15 and S16).

Figure S14: Countries with higher endowments of human capital specialize in relatively more skill intensive export sectors

Index of human capital per person vs. skill intensity of exports, 2014



Source: Author’s calculations using data from Penn World Table, U.S. Standard Industrial Classification (SIC), and UN Comtrade (mirror data).

Note: The orange dot represents Cambodia and the gray dots represent the comparator countries of Bangladesh, Sri Lanka, Malaysia, Thailand, and Vietnam.

Cambodia and Bangladesh, in contrast, have seen stagnating human capital intensity of their export baskets, and less improvement in human capital. Only recently has Cambodia experienced an uptick in the skill intensity of its export basket.

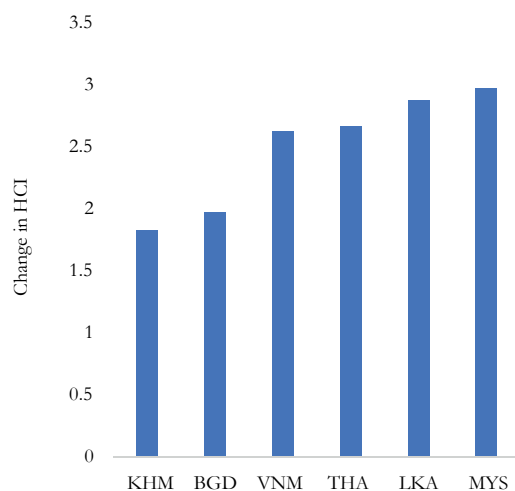
At the same time, an inadequately trained workforce could be preventing Cambodia from moving into higher value-added products and diversifying its economy. The lack of skills appears to be a binding constraint for firms. The most recent World Bank enterprise survey revealed that a significant percent of firms found an inadequately trained workforce to be among their top three constraints, higher than other regional countries except Lao PDR. A similar share of firms in the World Economic Forum's Executive Opinion Survey signaled an unskilled workforce as a significant impediment to conducting business. Firms reported that a lack of skills could lead to lower worker productivity and hurt business as a result of delays in developing new products and services, an increased workload for other workers, difficulties in meeting customer service objectives, lost business to competitors, and difficulties meeting quality standards (World Bank 2019c). Cambodia's success will depend heavily on its ability to accumulate human capital and increase

the skills of its workforce.

Yet there is high demand for skills in Cambodia, indicated by high returns to completing secondary and tertiary education (World Bank 2019c) and relatively high turnover rates (World Bank 2017). Completing upper secondary schooling and college has large payoffs in Cambodia in terms of individual's increased expected income to each additional year of education. The first 11 years of schooling (before completing upper secondary) have an average return of only 1.3 percent for every year of schooling. This is much lower than the average returns in other countries, which are 10.6 percent per year for primary and 7.2 percent per year for secondary. It seems the labor market does not put much value on the skills that are acquired in these initial years. However, individuals who have completed upper secondary schooling earn wages that are 9 percent higher than those earned by workers with only 11 years of schooling. Completing college or higher provides an additional return of 14 percent per year of schooling. Internationally, average returns to a year of tertiary schooling are similar to those in Cambodia, at around 15 percent (World Bank 2019c).

Figure S15: Countries like Vietnam that have improved human capital...

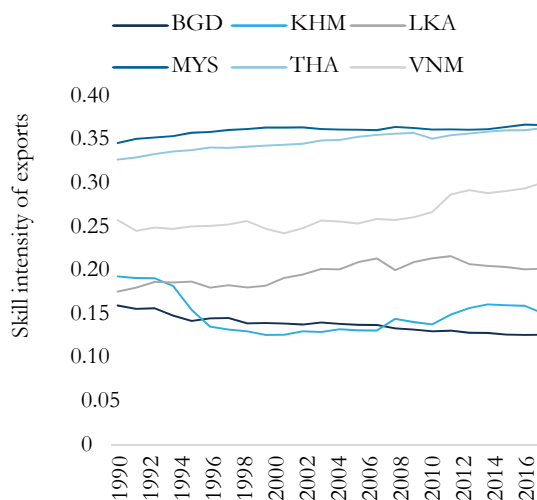
Change in index of human capital per person, 1990–2014



Source: Author's calculations using data from Penn World Table (PWT).

Figure S16: ...have also improved the skill intensity of exports

Trade-weighted skill intensity (ratio of skilled to unskilled workers) of a country's export basket



Source: Author's calculations using data from U.S. Standard Industrial Classification (SIC) and UN Comtrade (mirror data).

5. Technological change and the future of GVCs

One important question confronting the region is the impact of the changing technology of production and what this means for GVCs as a path for development. These labor-saving technologies, especially automation and 3D printing, will likely pose both opportunities and challenges for countries' future participation in GVCs, including Cambodia's.

First, technologies of distribution, like digital platforms, are creating opportunities for SMEs to sell to the world, which can potentially benefit Cambodia. Yet in Cambodia, the share of firms with a website is lower than in comparator countries, as well as regionally and globally (figure S17).

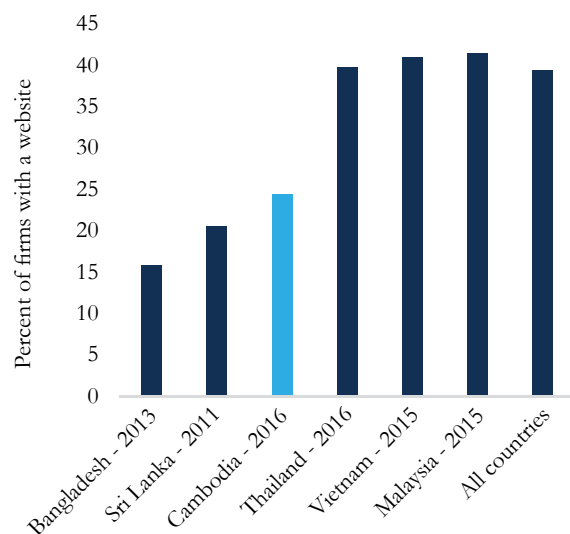
Second, while automation is not necessarily an immediate threat to the Cambodian economy, some jobs will disappear while others will be created. For instance, the availability of online services for mobile banking, travel bookings, and public services through e-government negatively affects workers in medium-skilled, routine-based occupations, such as tellers and clerical jobs. Machines are taking over routine tasks or parts

of the production process. Technological change means that 21st century workers require a more complex set of skills than in the past. Jobs are increasingly knowledge-intensive and technology based. There has been a global shift away from manual, routine jobs and into nonroutine, knowledge-intensive jobs. This may make human capital and skills more important for GVC participation going forward.

Third, there is a risk that these technologies could bring production closer to consumers at home and reduce labor-intensive imported inputs from developing countries. But the evidence so far suggests that these technologies are enhancing the contribution of GVCs to development. Automation has encouraged countries to use less labor-intensive methods of production, including in developing countries. But it has also contributed to higher productivity and a larger scale of production, which has increased the demand for imports of inputs from developing countries. In fact, the sectors that are the most automated are also the ones seeing the fastest growth in imports from developing countries (figure S18). Technological change is likely to be more a boon than a curse for trade and GVCs, at least at this stage (World Bank 2019a).

Figure S17: Fewer small and medium-sized establishments in Cambodia have their own website

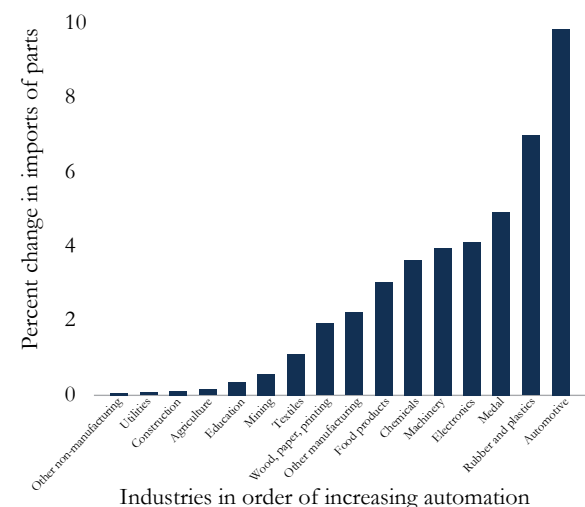
Share of establishments in the Enterprise Surveys that have their own website



Source: Author's calculations using data from World Bank Enterprise Surveys.

Note: Small and medium-sized firms are firms with less than 100 employees.

Figure S18: Increased adoption of industrial robots in the north has promoted imports from the south



Source: World Bank 2019a.

Conclusion

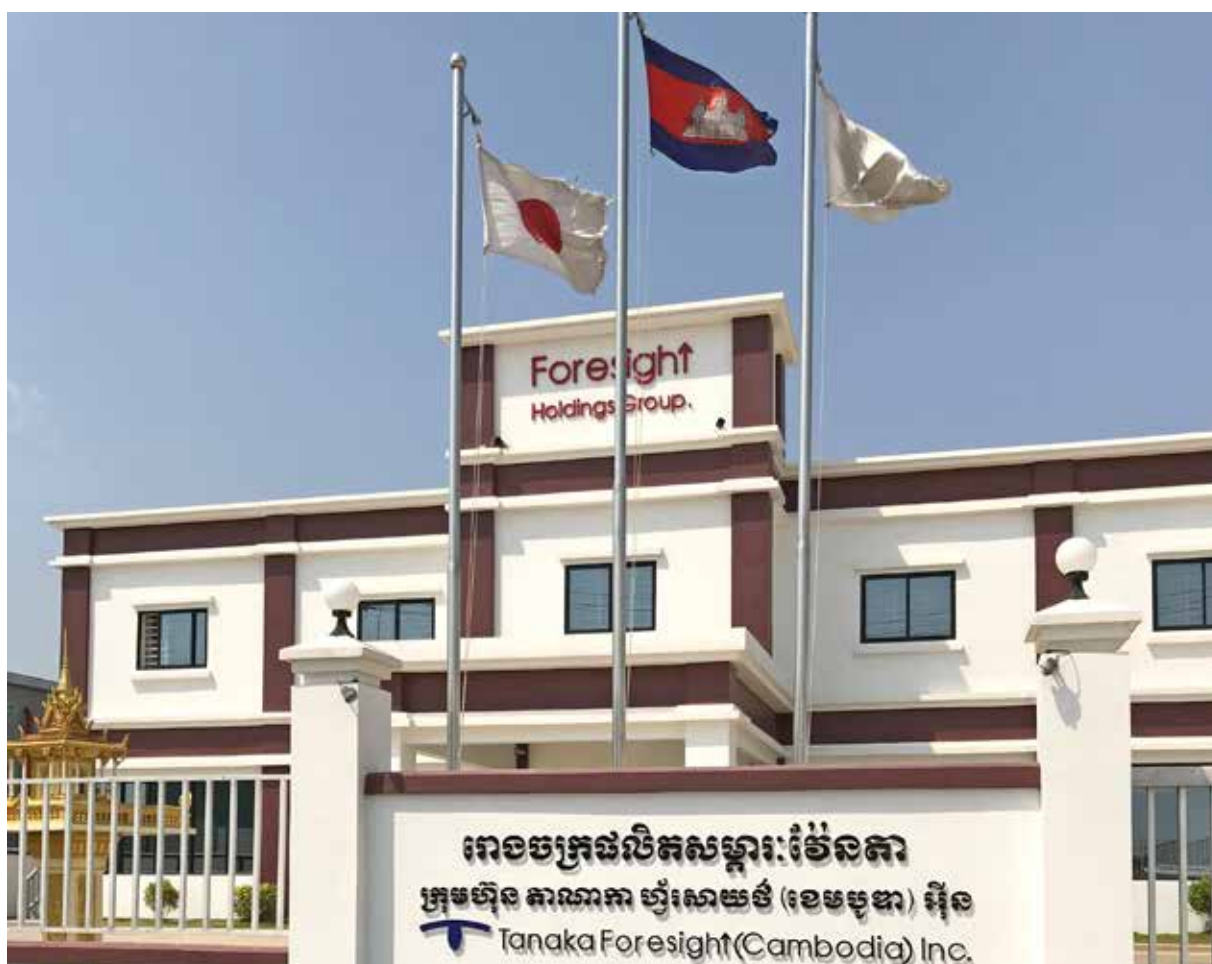
Despite Cambodia's remarkable participation in GVCs since the mid-1990s, the recent years have been marked by stagnation. Unlike other countries in the region, Cambodia has not been able to diversify outside of or upgrade within garments and footwear. To move to the next stage of participation, a much more sophisticated policy mix is needed, which should include the following.

First, expand and deepen trade agreements to go beyond issues of market access and national treatment. Attention should also be paid to contract enforcement, protecting intellectual property rights, and strengthening national certification and testing capacity to ensure compliance with international standards to facilitate greater GVC participation.

Second, lower barriers to trade and connect to markets to expand Cambodia's small domestic market size and improve access to the inputs needed for production. Reducing tariffs, improving customs and border procedures, promoting competition in transport and logistics services, improving the business environment, and enhancing port structure and governance can reduce trade costs related to time and uncertainty of trading.

Third, continue improving the education and skills of Cambodia's labor force. To strengthen domestic capacity to support upgrading in value chains, Cambodia should invest in human capital. The Penang Skills Development Centre in Malaysia is an example of an industry-led training center that has played an important role in supporting Malaysia's upgrading to electronics and engineering GVCs (World Bank 2019a).

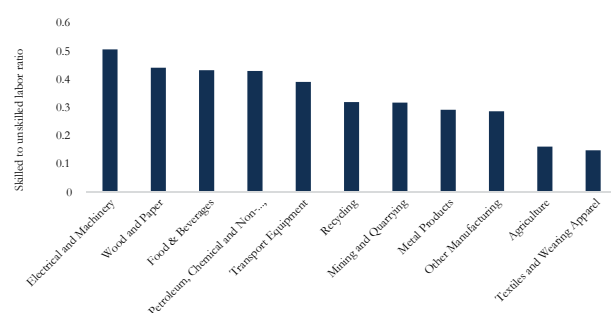
Fourth, harness the digital economy to support firms to integrate into GVCs through digital platforms as well as by connecting value chain participants.



Annex 1: Additional figures

Figure A1: Different GVC sectors require a more educated workforce for production

Ratio of skilled to unskilled workers at the sectoral level based on US national accounts data



Source: Author's calculations using data from U.S. Standard Industrial Classification (SIC).

Note: Skilled is proxied by having achieved tertiary education.



Annex 2: Cambodia's Key Indicators

	2016	2017	2018	2019p	2020f	2021f
Output and Economic Growth						
Real GDP (percent change, yoy)	7.0	7.0	7.5	7.0	6.8	6.8
Domestic demand (percent change, yoy)	9.9	7.8	8.7	11.7	12.5	9.0
GDP per capita (US\$, nominal)	1,264.9	1,363.1	1,500.5	1,612.2	1,747.1	1,910.2
GNI per capita, Atlas method (current US\$)	1,140.0	1,230.0	1,380.0			
Money and Prices						
Inflation, consumer prices (annual %, period average)	3.4	2.3	4.1	2.1	3.1	3.0
Broad money (percent of GDP)	79.2	88.2	100.7	118.8	136.6	154.4
Domestic credit to private sector (percent of GDP)	81.7	86.7	99.6	117.5	135.1	152.7
Nominal Exchange Rate (local currency per US\$)	4,058.0	4,062.0	4,067.0	4,075.0	4,082.0	4,050.0
Nominal Effective Exchange Rate (2015=100) ^{1/}	100.6	100.5	99.8	100.7	101.1	102.9
Real Exchange Rate Index (2015=100)	101.4	100.4	99.5	101.6	105.1	107.0
Short-term interest rate (percent p.a.)	11.9	11.7	7.1	8.0	8.2	8.0
Fiscal						
Revenue (percent of GDP)	20.7	21.6	23.6	23.5	23.3	22.9
Expenditure (percent of GDP)	22.1	23.6	24.3	24.2	28.2	27.4
Overall Fiscal Balance (percent of GDP)	-1.4	-2.0	-0.7	-0.6	-4.9	-4.5
Primary Fiscal Balance (percent of GDP)	-1.0	-1.7	-0.3	-0.1	-4.4	-4.1
General Government Debt (percent of GDP)	29.1	30.3	30.6	30.0	30.1	31.1
External Accounts						
Export growth, f.o.b (nominal US\$, annual percent)	8.6	5.3	5.3	9.3	8.2	8.9
Import growth, c.i.f (nominal US\$, annual percent)	8.6	4.1	4.1	7.7	7.7	7.7
Merchandise exports (percent of GDP)	45.5	45.6	46.0	47.6	48.2	48.5
Merchandise imports (percent of GDP)	56.9	56.1	55.1	58.5	60.9	60.6
Services, net (percent of GDP)	7.0	7.1	7.4	8.7	8.9	9.4
Income, net (percent of GDP)	-7.2	-7.2	-7.6	-7.6	-8.8	-9.2
Current account balance (current US\$ millions) ^{2/}	-2,312.5	-2,332.9	-2,289.2	-2,624.3	-3,665.6	-3,888.1
Current account balance (percent of GDP)	-11.6	-10.6	-9.4	-9.8	-12.5	-12.0
Foreign Direct Investment, net inflows (current US\$ millions)	2,395.3	2,663.5	3,071.7	3,149.9	3,494.9	3,717.0
Gross international reserves (millions US\$)	6,730.8	8,757.9	10,143.7	12,172.5	14,363.5	16,518.1
(prospective months of imports of g&s)	4.7	5.4	5.3	5.6	5.6	5.5
Memo: Nominal GDP (millions US\$)	20,020.2	21,906.1	24,476.1	26,682.6	29,324.0	32,498.9

Sources: Cambodian authorities, IMF and World Development Indicators, and World Bank staff estimates and projections

Note:

f = forecast.

p = projection.

^{1/} An increase = appreciation.

^{2/} Excluding transfers.

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