Cambodia

Accelerating exports, tourism, and investment fueled strong GDP growth in 2018. Inflation nevertheless slowed. The current account deficit widened, but rising foreign direct investment drove currency reserves higher. A weaker external environment will likely soften growth this year and next, with inflation remaining subdued and the current account deficit narrowing. A skills gap must be closed to extend high GDP growth beyond Cambodia’s waning phase of cheap labor before its demographic dividend expires.

Economic performance

Economic expansion last year hit 7.3% on a hefty increase in exports, buoyant tourism, and continuing strong foreign direct investment (FDI) inflows (Figure 3.23.1). Growth in the dollar value of exports of goods and services rose from 10.7% in 2017 to an estimated 18.3% in 2018. The value of merchandise exports alone jumped by the same estimated 18.3%, almost doubling a 9.3% rise in 2017. International tourist arrivals rose by 10.7%, with those from the People’s Republic of China building on a 45.9% increase in 2017 with a further 70.0% surge last year (Figure 3.23.2). Growth in FDI inflows edged up from 12.6% in 2017 to an estimated 13.0%.

By sector, agriculture likely grew by 1.8%, and growth in industry accelerated to an estimated 10.8%, up by more than a percentage point from 2017 thanks to impressive growth in garments and footwear. Construction was also brisk, with growth rising from 18.0% in 2017 to 19.0%. Services maintained growth at 6.9%.

Even as growth accelerated, inflation slowed from 2.9% in 2017 to 2.5% last year. Stable food prices and government measures to contain fuel price increases tamped down inflation, as did appreciation of the Cambodian riel along with the US dollar, which is widely used in Cambodia for all but the smallest purchases.

Stronger growth was accompanied by a widening of the current account deficit as growth in imports outpaced that of exports. Growth in merchandise imports more than doubled in dollar terms from 9.8% in 2017 to an estimated 20.0% last year, driven largely by rising imports of materials and components for export-oriented garment and footwear production and higher imports of construction materials.

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The current account deficit excluding official transfers likely widened from the equivalent of 10.5% of GDP in 2017 to 13.6% (Figure 3.23.3).

Continued strength in FDI inflows more than offset the current account deficit, enabling gross foreign exchange reserves to rise to about $10 billion at the end of 2018, or cover for 5.6 months of imports. Reserves exceeded external public debt.

Based on the government’s table of financial operations, the 2018 budget was expansionary, with a deficit equal to 5.1% of GDP, somewhat higher than a 3.1% budget deficit realized in 2017 (Figure 3.23.4). Expenditure was budgeted to equal 22.9% of GDP and revenue 17.8%. By December, though, actual revenue had exceeded the budget target, but expenditure seemed to have lagged.

Monetary policy continued to be anchored on maintaining a stable exchange rate between the riel and the US dollar and on ensuring that ample credit availability continued to support growth. Credit to the private sector grew by 23.2% in 2018, nudging up the ratio of private sector credit to GDP to 83.3% by year-end.

### Economic prospects

A growth slowdown that is now forecast for the advanced economies and the People’s Republic of China—major destinations for Cambodian exports—will likely soften prospects for growth in exports and tourism arrivals. GDP growth is thus seen to moderate to 7.0% this year and 6.8% in 2020 (Figure 3.23.5).

By sector, industry and construction are expected to feel the adverse effects of the weakening external environment the most. Growth in industry is likely to slow to 10.1% in 2019 and 9.4% in 2020, and construction to 17.0% this year and 16.0% next year. Growth in services will slow but only marginally to 6.8% in 2019, as will growth in agriculture to 1.7%.

With slowing growth, lower international oil prices, and stable food prices, inflation should remain subdued, the average staying at 2.5% both this year and next.

Moderating growth and subdued inflation should narrow the country’s current account deficit, as shown in particular by imports of raw materials for export production. The current account deficit is seen narrowing to the equivalent of 12.7% of GDP this year and 11.8% next year. Robust FDI inflows should more than offset the current account deficit, pushing gross international reserves to $12 billion in 2019, or cover for about 6 months of imports—and, again, more than external debt. The ratio of external debt to GDP should thus remain at a sustainable 30.0%.

With growth softening, fiscal policy is targeting a narrower budget deficit this year, equal to 4.5% of GDP, according to the government’s table of financial operations.
Monetary policy will continue to maintain the value of the riel against the dollar. The government aims to gradually wean the economy of dollarization with greater use of the riel and is slowly but steadily pushing banks’ prudential norms toward international benchmarks.

A key external risk to the outlook would be a global economic slowdown steeper than currently anticipated. Another is the European Union carrying through with its plan to suspend trade preferences for Cambodia under the Everything But Arms program that it extends to least-developed countries. Notable domestic risks are a rising ratio of credit to GDP and possible drought this year.

**Policy challenge—closing a skills gap**

Cambodia has achieved high growth by offering low-cost labor, but this phase of its development is drawing to a close. Sustaining strong growth in the future will increasingly require the country to build a skilled workforce that can easily adapt to rapid technological changes sweeping the global economy, including automation and robotics.

Over the years, Cambodia has achieved notable progress in education, but a number of recent surveys and studies highlight that investors and businesses are constrained by a widening gap between the skills the workforce possesses and those it needs. Reflecting this, the World Bank Human Capital Index 2018—a composite measure of enrollment and dropout rates, average number of years of schooling, and learning quality while in school—ranks Cambodia just above the Lao People’s Democratic Republic and Myanmar, among its peers in the Association of Southeast Asian Nations, but its index score of 0.49 falls far short of Viet Nam’s 0.67 (Figure 3.23.6). A worsening mismatch between the skills demanded by industry and business and those imparted to youth in school, including in institutions that specialize in technical and vocational education and training (TVET), is the most important factor causing this skills gap. Unless it can be closed expeditiously, Cambodia will squander the demographic dividend it enjoys in having a young and expanding workforce.

The government recognizes the urgency of closing the skills gap. It recently announced its National TVET Policy, 2017–2025, which focuses on forging much closer collaboration between educational institutions and private businesses. This collaboration promises to make education more market driven. Regular information flows between private firms and TVET institutions, and collaboration in developing and operationalizing TVET curricula, promise to ensure that the skills imparted align with those in demand. To help keep students in school and learning the skills needed for the digital age, Cambodia needs more and better teachers and financial support for poor children and outstanding students.