

Export Diversification in Cambodia: The Role of Foreign Direct Investment and Human Capital

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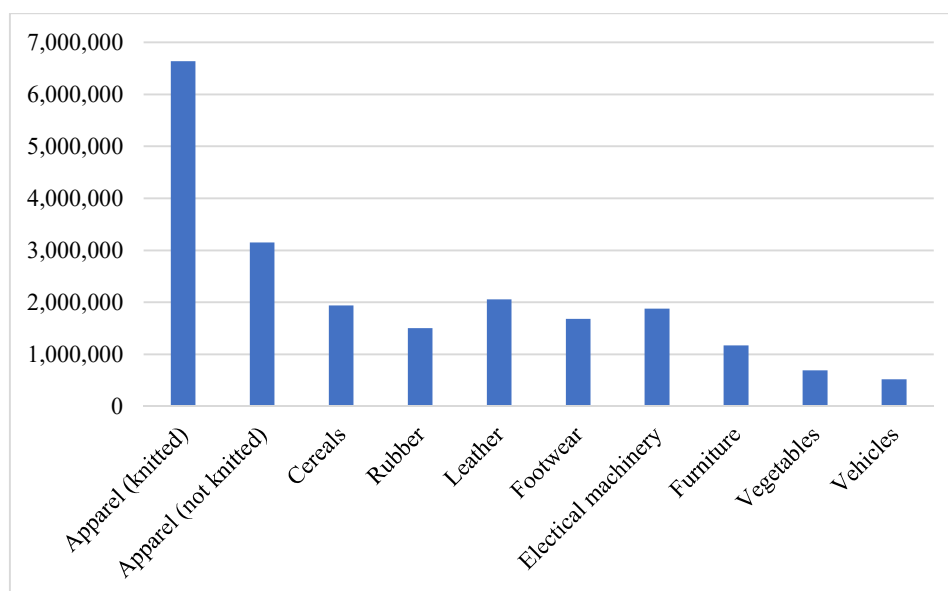
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1. Introduction

Cambodia is a small, open economy. According to the latest data, trade, which is the sum of imports and exports, accounts for over 130 percent of the Gross Domestic Product (World Development Indicator 2025). Exports alone represent approximately 67 percent of the GDP, making them a significant driver of Cambodia's economic growth over the past three decades. Trade openness enables a small economy to access larger markets, integrate into global supply chains, and import essential raw materials and capital goods that are not produced domestically. Trade enables specialization by facilitating the exchange of agricultural commodities for high-tech manufactured goods and services. This means that, thanks to trade, a country does not need to produce a wide variety of goods for domestic consumption but can focus on producing what it can at the lowest opportunity cost, and by so doing, social welfare is improved. In principle, trade liberalization enhances the welfare of both exporting and importing economies. Exports, in particular, offer various benefits, including job creation, attracting Foreign Direct Investment (FDI), and providing opportunities to diversify the economy away from traditional sectors, ultimately contributing to an improved standard of living for the population. From 1993 to 2023, Cambodia's exports have expanded more than 60-fold, from approximately USD 349 million to 21.3 billion (World Development Indicators 2025). This growth has been primarily driven by manufactured goods produced by Foreign Direct Investment (FDI) firms in the garment and footwear industries, as well as several agricultural commodities, particularly rice, which has dominated agricultural exports since the country achieved self-sufficiency in rice production in 1996. Cambodia attracts FDI in garment and footwear, and other light industries due to its low-cost labor and trade preferences such as the Generalized System of Preferences (GSP) and the Everything But Arms (EBA) initiative, granted by the US and European Union. While exports bring numerous benefits, over-reliance has negative consequences such as labor exploitation, environmental degradation, economic variability, and being subject to importing countries' tariff policies. Additionally, dependence on undiversified exports—limited export commodities and markets—makes the economy even more vulnerable to external shocks. Cambodia's exports are notably undiversified in both composition and markets. Despite efforts to diversify, garment and footwear exports remain dominant, accounting for about 60 percent of total exports in 2021, declining from the peak of 80 percent in 2015; other main exports include machinery and electronic parts, plastics and rubbers, and agricultural products (ADB, 2024). Figure 1 shows that apparel and clothing products are the main export commodities, followed by other light manufacturing and agricultural products, including footwear, cereals and leather.

Figure 1. Top 10 Export Commodities in 2024¹



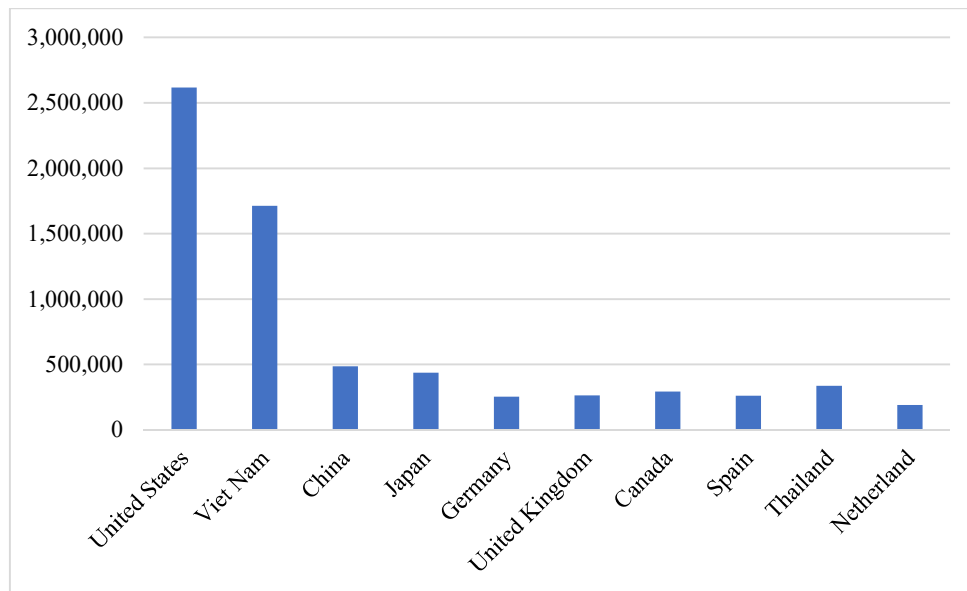
Source: General Department of Customs and Excise

Regarding export markets, the US and EU represented about 60 percent of export values in 2021, with other important markets including Japan, the People's Republic of China, and Canada (ABD, 2024). The relatively less diversified exports render Cambodia vulnerable to external shocks, and limit the potential of exports as a driver of growth. Therefore, it is crucial to analyze the impact of diversifying exports on the economy and how FDI contributes to these diversification efforts. Figure 2 shows that the US is the largest importer of Cambodian products, followed by Vietnam, China, and Japan. Given the significance of the US market, the imposition of a 49 percent tariff² on Cambodian products by the Trump administration will have a substantial impact on employment and economic growth in Cambodia.

¹ The formal categories of some commodities are as follows: **Apparel (knitted)** is Articles of apparel and clothing accessories, knitted or crocheted, **Apparel (not knitted)** is Articles of apparel and clothing accessories, not knitted or crocheted, **Rubber** is Rubber and articles thereof, **Leather** is Articles of leather; saddlery and harness; travel goods, handbags and similar containers; articles of animal gut (other than silk-worm gut), **Footwear** is Footwear, gaiters and the like; parts of such articles, **Electrical machinery** is Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers, and parts and accessories of such articles, **Furniture** is Furniture; bedding, mattresses, mattress supports, cushions and similar stuffed furnishings; lamps and lighting fittings, not elsewhere specified or included; illuminated signs, illuminated name-plates and the like; prefabricated buildings, **Vegetable** is Edible vegetables and certain roots and tubers and **Vehicles** is Vehicles other than railway or tramway rolling-stock, and parts and accessories thereof.

² Please see: <https://www.phnompenhpost.com/national/cambodia-tops-list-of-new-trump-tariffs-49->

Figure 2. Top 10 importers of Cambodian products in 2024



Source: General Department of Customs and Excise

2. Diversification of exports and its impact on the Cambodian economy

Small economies face challenges due to their small population, which means the domestic market is insufficient to absorb large-scale production, inhibiting invention and innovation. When the market is not large enough, firms cannot reap the benefits from economies of scale, and are thus reluctant to develop new products. Additionally, a small geographical area means limited natural resources. Consequently, small economies must rely on the export market to scale up production and sell their products, as well as import raw materials for production. Openness to trade allows these economies to benefit from economies of scale by accessing large export markets, and diversifying production for export by importing resources that are not available locally.

Ricardo's theory of comparative advantage suggests that a country should produce and export goods in which it has a comparative advantage. Cambodia's comparative advantage lies in the production and export of labor-intensive manufacturing and agricultural products. The exports from these sectors are not highly diversified, with garments and textiles dominating the manufacturing sector (Saing et al., 2019), while rice is the primary export in agriculture. Since the Cambodia-China Free Trade Agreement (CCFTA) was in effect, new crops such as Cavendish bananas, longan and mangoes, as well as aquaculture products, have been exported to China. In addition, there has been an increase in Chinese FDI firms investing in Cambodia³. However, specializing in these low-value-added industries will not be promising for the country in the long run, as it will lead to unfavorable terms of trade, with import prices rising relative to export prices. In the long run, the country may become stuck in a low equilibrium.

Undiversified exports and a comparative advantage in low-value-added production are challenges that Cambodia faces and must address. As the country strives to diversify its exports, it is crucial to focus on higher-value-added production. Export diversification has been found to allow small economies to reduce production volatility and promote higher economic growth (McIntyre et al., 2018).

³ Please see: <https://www.phnompenhpost.com/business/cambodia-china-fta-brings-growth>

Recognizing the importance of export diversification for economic growth and resilience, the Cambodian government has outlined this strategy in the Cambodia Industrial Development Policy (IDP) 2015-2025⁴. The policy aims to increase the share of non-textile exports and processed agricultural products to 15 percent and 12 percent of total exports by 2025, respectively.

Which export products should Cambodia consider diversifying into?

Cambodia may consider two strategies for export diversification. The first, less ambitious strategy focuses on sectors with existing comparative advantages, such as food processing, garments, and light machinery, as outlined in the IDP 2015-2025. The second, more ambitious strategy targets high-tech and heavy machinery exports⁵. According to Trung (2024), it is practical for Cambodia to adopt a less ambitious strategy that leverages its existing strengths and resources before transitioning to a more ambitious approach. The World Bank also recommends diversifying manufactured and processed agricultural products⁶. However, given the government's commitment to becoming an upper-middle-income country by 2030 and a high-income country by 2050⁷, the ambitious strategy is more plausible. Cambodia must create a comparative advantage in higher-value-added industries.

Is it possible for a country to move from one comparative advantage to another? Comparative advantage is not fixed and can change over time due to changing factor endowments, resource availability, and demand. The Republic of Korea is a prime example of an economy that has successfully created a new comparative advantage. Korea's original comparative advantage was in cheap labor, due to its abundant supply of diligent workers (Kim, 1991). Through industrial policies and heavy investment in human capital, Korea has successfully transformed and created a comparative advantage in high-tech and technologically sophisticated productions. Korea is not an exception; other economies in East Asia, such as Japan and Taiwan, have also successfully created new comparative advantage. The success of East Asia provides indispensable lessons for latecomers like Cambodia to contextualize and adapt policies suitable for implementation. While the current global trade environment differs from when East Asia began their development journey, latecomers may take advantage of a relatively open global market despite fiercer competition. Technology can now be transferred faster and more cheaply, and the movement of capital and labor is freer. FDI is welcomed all over the world. What remains constant is the need to invest in human capital and improve the capacity of the population to digest fast-growing information and rapidly advancing technology. Without high-quality human capital, it is difficult to diversify exports and shift the comparative advantage. In this journey, FDI also plays an important role in addressing the shortage of capital and facilitating technology transfer.

Diversifying into higher-value-added industries: the role of FDI and human capital investment

FDI plays a crucial role in Cambodia's industrialization by substituting for the limited domestic savings and technical know-how. It began flowing into Cambodia in the early 1990s, as the country started to emerge from two decades of conflict, which ended in 1998. The FDI inflows were initially

⁴ Please see: <https://cdc.gov.kh/wp-content/uploads/2022/04/IDP-English.pdf>

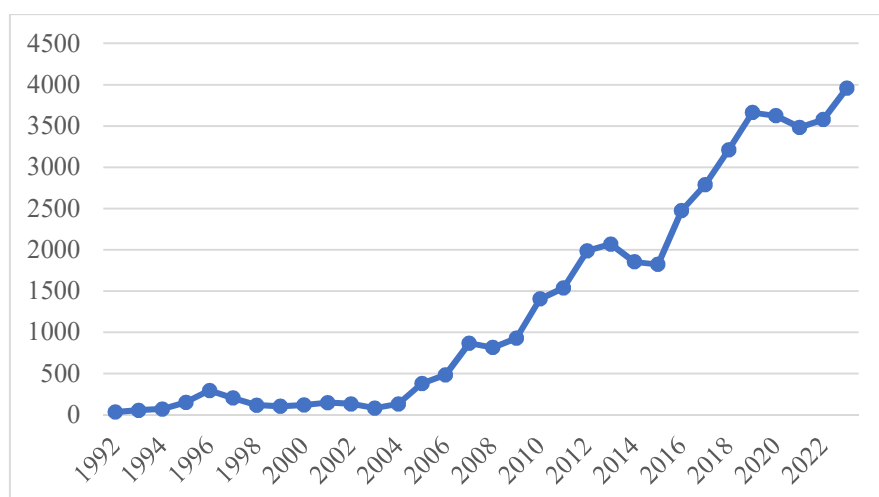
⁵ <https://amro-asia.org/moving-up-how-can-cambodia-achieve-export-diversification>

⁶ <https://cambodiainvestmentreview.com/2024/12/17/world-bank-report-2024-recommends-diversifying-trade-improving-productivity-to-shore-up-growth-in-cambodia/>

⁷ Cambodia reached a lower middle-income status in 2015. For more information, please see: <https://www.worldbank.org/en/country/cambodia/overview>

very small, but they increased significantly after 2015 (Figure 3). Through FDI, the garment and footwear industry was born, with factories from East Asian countries, primarily mainland China, relocating to Cambodia to take advantage of preferential tariffs such as the Generalized System of Preferences (GSP) and the Everything But Arms (EBA) for the US and EU markets. Since then, industrialization has gradually gained momentum, diversifying the production from garments to travel goods and electronic parts.

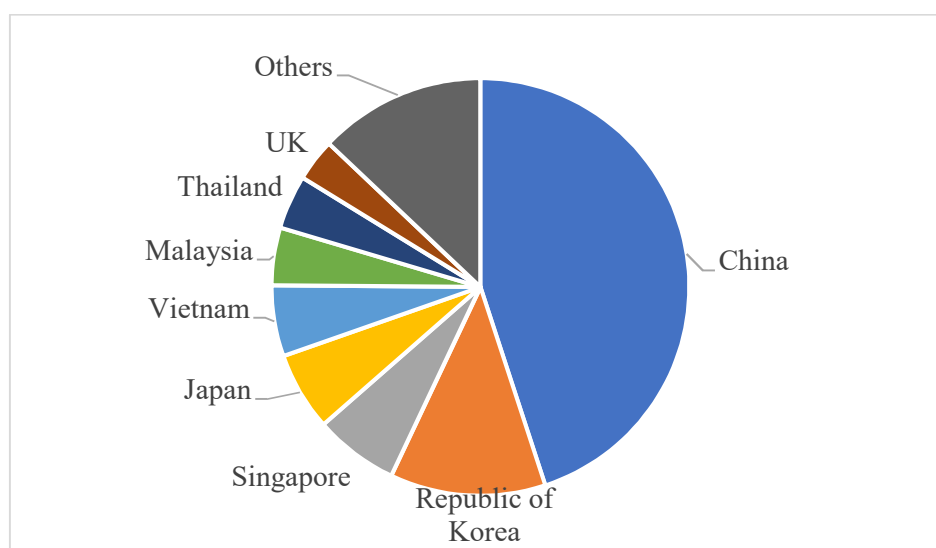
Figure 3. FDI, net inflows (current USD)



Source: World Bank's World Development Indicators

It is worth noting that most of the FDI inflows into Cambodia are from the countries in the East Asian region, with China being the largest investor, followed by the Republic of Korea, Singapore, Japan, and Vietnam (Figure 4).

Figure 4. FDI Inflow by Countries, 2023



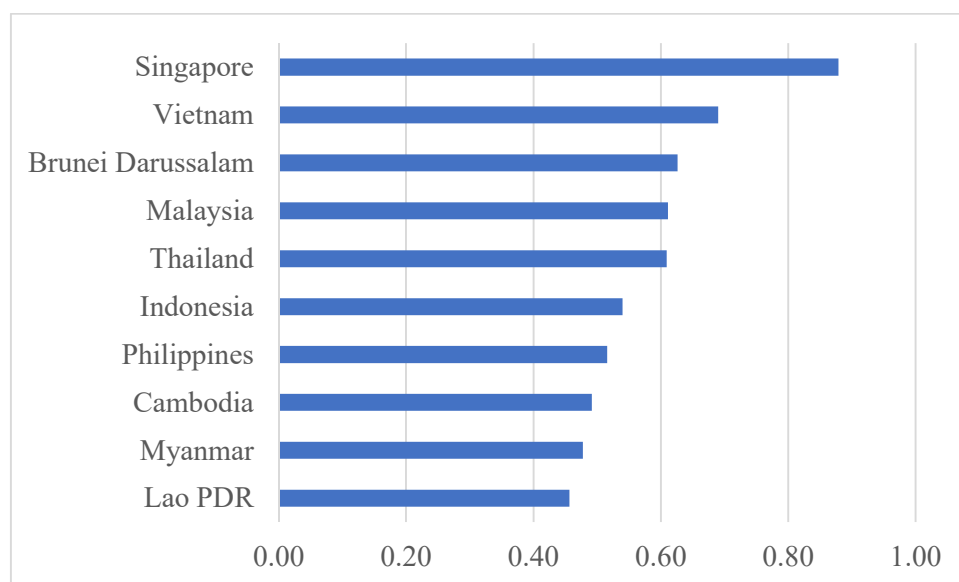
Source: Council for the Development of Cambodia and National Bank of Cambodia

Note: China's figures included Taiwan, Hong Kong, and Macao

The importance of foreign firms cannot be overstated, and Cambodia needs to attract more sophisticated and higher-tech companies. The benefits of FDI include technological and management know-how, which local firms can absorb through imitation, machinery imports, and other spillover effects, all of which are vital for diversification efforts⁸. Therefore, if only firms interested in light industry, without introducing significant technology, invest, the local firms and labor forces will not benefit much from technology transfer. To maximize the benefit of FDI, it is essential to build strong human capital, which attracts FDI specialized in the field of technology. The World Bank recommends increasing investment in human capital if Cambodia aspires to achieve a higher income status⁹, as demonstrated by the successful experiences of East Asian economies like Japan, the Republic of Korea, and Taiwan. Only with an educated labor force can Cambodia attract high-tech FDI. Over the past three decades, most FDI firms investing in Cambodia have been efficiency-seeking, operating factories in the garment, textile, and light industries to benefit from cheap labor. Therefore, it is crucial to improve human capital to attract high-quality FDI.

Human capital encompasses both the skills and health of the people. By various metrics such as the average years of schooling and life expectancy at birth, Cambodia lags behind countries in the region. According to the World Bank's Human Capital Index (HCI), which calculates the contribution of health and education to workers' productivity, in 2020, compared to other Southeast Asian countries, Cambodia's HCI is higher than only those of Myanmar and Lao PDR; with a score ranging from 0 to 1, Cambodia scored 0.49 (Figure 5).

Figure 5. Human Capital Index in Southeast Asia



Source: World Bank's World Development Indicators

⁸ Please see :

https://www.nbc.gov.kh/download_files/macro_conference/english/S3_FDI_AS_A_DRIVER_OF_CAMBODIA_EXPORT_SOPHISTICATION_AND_DIVERSIFICATION.pdf

⁹ Please see: <https://www.worldbank.org/en/country/cambodia/overview>

In addition, Cambodian students scored the lowest in the Program for International Student Assessment (PISA) reading¹⁰ and science¹¹. Using other indicators, such as the number of scientific publications, Cambodia also ranks low among other Southeast Asian countries¹². In addition to lower outcomes related to human capital, there are issues of skill mismatch and youth unemployment, which discourage young people from enrolling in general education. Furthermore, social norms and cultural factors deter youth from pursuing technical skills¹³, which are crucial for attracting FDI and absorbing technology. Vocational skills were less valued by society. These problems and outcomes indicate significant potential for improving human capital in Cambodia, which is crucial for attracting FDI and diversifying exports. While factors such as infrastructure, governance, institutions, and law and regulations are also vital for attracting FDI, human capital remains one of the important factors.

3. Conclusion and Implications

Export diversification plays an important role in a small open economy like Cambodia. While heavy reliance on trade and exports makes the economy dependent on external policies beyond the control of domestic institutions, a small economy has little choice but to leverage exports for economic growth and development, and for improving the welfare of the people. However, diversifying based on existing comparative advantages will not suffice for Cambodia to achieve the goal of transforming from lower-middle-income to upper-middle-income, and ultimately to high-income status. Cambodia needs to create a new comparative advantage in high-tech and knowledge-based industries. This is feasible if human capital is improved to a level where the economy can rapidly adapt, adopt newly invented and cutting-edge technologies, and innovate. This implies that the government should finance human capital investment to levels similar to those seen in East Asia and encourage both public and private research and development. The role of FDI over the last three decades has been indispensable, particularly in job creation, technology transfer, and increased tax revenue. However, Cambodia must now start to attract FDI in higher value-added and high-tech industries to further the development. To achieve this, it is essential to create an environment conducive to such FDI, including improved infrastructure, laws and regulations, and enhanced human capital.

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¹⁰ Please see: https://www.theglobaleconomy.com/rankings/pisa_reading_scores/South-East-Asia/

¹¹ Please see: https://www.theglobaleconomy.com/rankings/pisa_science_scores/South-East-Asia/

¹² Please see: <https://www.unesco.org/reports/science/2021/en/southeast-asia-oceania>

¹³ Please see: <https://www.khmertimeskh.com/501403688/government-urges-youth-to-consider-vocational-training/>

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