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The contribution of MNEs to economic success in small open economies: the case of Cambodia[1]

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CAS Discussion paper No 58

January 2008

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1. Introduction

Firms serve markets outside the boundaries of their home country by exporting their products, licensing their technology, or engaging in international production abroad through foreign direct investment (FDI). The existing literature provides a series of reasons for such outward FDI, e.g., that the investing firms possess specific ownership advantages over the indigenous, local firms, which they want to exploit or want to tap into local resources which are unavailable or relatively more expensive, in their own countries.

This chapter reviews Cambodia's inward FDI and the role that FDI has played in its economic growth and the expansion of exports in a competitive environment. Based on previously unpublished data from the Council for the Development of Cambodia (CDC)/Cambodian Investment Board (CIB), inward FDI flows into Cambodia are categorized into two main types—approved FDI and realized or active FDI. Approved FDI consists of the investment projects that received approval from CDC, while realized or active FDI is referred to as the investment projects that have become operational following approval from the CDC or CIB.[5]

The chapter is organized as follows. In the second section, a short overview will be given of the relevant economic and business environment for FDI in Cambodia. Using unique data, FDI in Cambodia is analyzed by geographic origin in section 3, by ownership categories in section 4, by industrial sectors in section 5, by provinces in section 6, and by distinguishing between approved and realized FDI in section 7. The role of FDI in Cambodia's economic development and the competitive advantages according to Michael Porter's "diamond" are discussed in sections 8 and 9, respectively. Some conclusions are presented in section 10.

Inward FDI often plays a vital role in the economic growth and development of a host country, more particularly of a small and less developed economy that needs to be integrated more intensely into the world economy. Inward FDI makes available to the recipient country not only the investment capital, but it also gives access to modern technology and know-how. It creates jobs, brings into the recipient country foreign exchange, which in turn can be used for the imports of the necessary productive capital goods, and often contributes significantly to output growth and to the expansion of exports. In addition, inward FDI may force the local (incumbent) firms to become more efficient if they are to survive in a more competitive environment.

More and more countries, especially developing countries, have become aware of these potential benefits and have made efforts to attract FDI, e.g. by creating special investment zones and export processing zones, by providing tax holidays, by allowing duty-free imports of capital goods, production materials and equipment and by introducing fast-track approval procedures for FDI by the government

[5] The distinction between approved FDI and realized FDI is based on the fact that investment projects are not necessarily realized in the same year in which they are approved. Some authorized investment projects may be postponed or may not be implemented at all.

administration authorities. Cambodia is no exception and has developed favourable policies to foreign investors.[6]

2. Cambodia's Business Environment for Foreign Direct Investment

Cambodia dramatically suffered from Pol Pot's genocidal regime (1975-1978), and by the ensuing civil wars and the invasion of foreign powers (1979-1989), which caused enormous destructions, not only to the country's infrastructure, educational institutions, financial and health systems, but even more importantly, to the human capital. Following the signing of the Paris Peace Accord in 1991, and the arrival of the United Nations Transitional Authority (UNTAC) Cambodia finally held its first democratic general election in 1993 (with more than 20 participating political parties), which resulted in the formation of a legitimate coalition government.[7]

To rebuild the decades-long, war-stricken country, Cambodia was in dire need of capital, and lacked the foreign exchange for importing essential capital goods. The need to build up the nation's capital stock was very acute and could to some extent be alleviated through inward FDI. Following the UN-sponsored election of 1993, Cambodia has engaged in the liberalization of its economy by promoting domestic investment and by adopting an extremely open policy towards foreign investment and international trade.[8] The so-called Law on Investment was enacted by the Cambodian National Assembly in 1994, leading to the creation of the Council for the Development of Cambodia (CDC). The Prime Minister-chaired CDC is the highest decision making government agency responsible for private and public sector investment, while the Cambodian Investment Board (CIB) acts as its private investment arm. The CIB reviews the investment applications and screens the investment projects.

The CIB serves as a one-stop agency for the screening of investment projects, both domestic and foreign ones. Once they are accepted by the CIB, the investment projects are eligible for a wide range of benefits as spelled out in the Investment Law of 1994. These incentives included a 9 per cent corporate income tax rate; an exemption of corporate tax for up to eight years; permission to carry forward losses for up to five years; non-taxation of dividends, profits or proceeds of investment; tax-free import of capital goods, intermediate goods and construction materials; tax-free exports; and the permission to hire skilled foreign employees. These benefits were available to the approved projects introduced by Cambodian investors or foreign investors on a non-discriminatory basis (Investment Law, 1994, 2003).

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[6] See Cambodia's Law on Investment (1994) or section 2 for more details about the availability of incentives for approved investment projects.

[7] Yet the disagreements and sporadic disputes that arose between the two ruling parties, i.e., the Cambodian People's Party (CPP) and the FUNCINPEC - led to an armed conflict in the centre of the capital city Phnom Penh in July 1997. The factional fighting shied away both established and potential foreign investors. FUNCINPEC is referred to as "Front Uni National Pour un Cambodge Indépendent, Neutre, Pacifique et Coopératif "(in English "National United Front for an Independent, Neutral, Peaceful, and Cooperative Cambodia").

[8] After the *Khmer Rouge* regime was overthrown in January 1979 with the help of the Vietnamese, Cambodia's economy became strictly controlled. It only started to liberalize its economy in 1985, but a more far-reaching liberalization was not realized until 1989, at the time the Vietnamese troops finally left the country (Hing, 2003, p. 12). See also Gottesman (2004).

The 2003 amendment to the Investment Law of 1994 has greatly simplified the license application procedures (Figure 1). Although there was an increase in the corporate tax rate from 9% to 20%, its level is still much lower than that in most of the neighbouring countries.[9] However, generous tax incentives may not be the best way to woo FDI inflows. Serious foreign investors are more likely to be attracted by the long-term economic prospects than by short-term tax advantages offered by the host country's government, but evidently no firm will refuse an important tax concession (Lall, 1995).

For the host countries there are pros and cons associated with offering tax holidays. Countries may become engaged in so-called 'tax tournaments' and compete with one another to attract FDI because generous tax incentives are often assumed to provide a country with a competitive advantage. Especially when the economic conditions of the competing countries are very similar there is a danger that as a result of such 'wars of competing incentives' all involved countries may lose out to the multinational enterprises (MNEs) when those firms decide to locate where they had intended to go even before the inter-country bidding started. In an effort to encourage more inward FDI, the Cambodian Prime Minister in 2006 urged the Ministry of Commerce to carry out administrative reforms to facilitate investment applications as well as imports and exports.

Figure 1: Comparison of Cambodian Investment Incentives 1994 versus 2003

Investment Law of 1994	Investment Law of 2003
Corporate tax of 9%	Corporate tax of 20%
Tax holiday up to 8 years	Trigger period + 3 years + Priority Period[10]
Tax free repatriation of profits	Repatriation of profits (subject to withholding tax)
Reinvestment of earnings (tax free)	Reinvestment of earnings (special depreciation)
No tax on imports of capital goods and intermediate goods	No tax on imports of capital goods and intermediate goods
No export tax	No export tax
Licensing (evaluation and approval)	Licensing (simple registration)

Source: Adapted from Hing (2006), p. 104.

Although relatively large amounts of foreign investment were attracted in Cambodia, long delays in investment approvals have been repeatedly reported and are partly due to the country's bureaucratic slowness (Hing, 2003, 2006). For investment projects exceeding US$ 50 million it is necessary to obtain authorization from the Office of the Council of Ministers. Moreover, approval from the Council of Ministers is required for e.g. politically sensitive projects; the exploration of mineral and natural resources, projects with possible negative environmental effects and infrastructure projects (CDC, 2007). These additional approval steps tend to delay the authorization process and result in fewer

[9] Lao PDR's corporate tax is 20-35%, Myanmar 30%, Thailand 30%, and Vietnam 10-20% (Hing, 2003, p.58).
[10] The so-called *trigger period* starts with the issuance of the final registration certificate and ends on the last day of the taxation year; the maximum trigger period is to be the first year of profit or three years after a qualified investment project earns its first revenue, whichever sooner (CDC, 2007). The trigger period is less than or equal to three years from the start of operation (Hing, 2006, p.103). *Three years* commence from the taxation year immediately following the trigger period and the two immediately succeeding years. The *priority period* commences immediately after the third taxation year of the three-year period (CDC/CIB: Laws and Regulations on Investment in the Kingdom of Cambodia, 2006).

projects being proposed or carried out and is one of the reasons for the differences between approved and realized investments.

Since 1994, one year after the election, the country increasingly tried to woo both domestic and foreign investment. Especially via its liberalization policy towards international investment and trade, Cambodia has attempted to improve its attractiveness for foreign investors as an export platform to third country markets, such as the lucrative American and European markets. During 1994-2004, inward FDI flowed into Cambodia from more than 26 countries.[11] Based on investment data measured in fixed assets, the most prominent countries of origin were Malaysia, Taiwan, China and the United States.[12]

Table 1 lists the percentage shares of FDI inflows into ASEAN countries over the period 1994-2004. Cambodia has only been marginally attractive to FDI, in comparison to its ASEAN member countries for 1994-1996. FDI flows into the country even declined during the two sub-periods of 1997-2000 and 2001-2004. The decline in FDI inflows was likely due to the internal political tension between the Cambodian People's Party (CPP) and the FUNCINPEC Party, which resulted in an armed conflict, undoubtedly shying away existing and potential investors.

The second major factor in the business environment, responsible for the decrease in inward FDI flows into Cambodia, has been the Asian financial and economic crisis of 1997. Thailand, Indonesia and Malaysia were hit hardest by the crisis (Tongzon, 2004, p. 155). This crisis, which started in Thailand, affected first Malaysia and Indonesia, and then spread out further to the less developed ASEAN economies of Cambodia, Vietnam, Lao PDR and Myanmar. Whereas the spread and contagion of the crisis in Malaysia and Indonesia was to some extent due to the psychological reaction of international investors and speculators and the weakness of the banking and financial sector in the countries involved, for the poorer transition economies it was triggered by the existing investment and trade linkages with the aforementioned stronger economies of Southeast Asia. The Cambodian economy relies heavily on foreign capital via foreign direct investment or financial assistance in the form of development loans. As intra-ASEAN investment is the largest part of Cambodia's inward FDI flows, the country became adversely affected, also because of fundamental weaknesses in its banking and financial sector. Cambodia's inward FDI in fixed assets from Malaysia alone accounted for more than one third of the total FDI in the country over the period 1994-2004. Since a major share of Cambodia's FDI comes from ASEAN members and other Asian countries, the adverse impact of the Asian crisis on Cambodia's inward FDI flows can be explained with reference to the relative costs of investment in Cambodia and those in the country of origin of the FDI. The crisis caused substantial devaluations of ASEAN home countries' currencies against the dollar, which implied that *ceteris paribus* payments in domestic currencies to the factors of production in FDI home countries were

[11] Some countries had very small amounts of investment in fixed assets during 1994-2004.
[12] Cambodian Investment Board (CIB), Cambodian Investment Statistics 1994-2004, unpublished data.

relatively less costly than payments to production factors in US dollar—the currency heavily used in business transactions in Cambodia.[13]

The third factor that possibly had a negative effect on FDI in Cambodia and the other Southeast Asian countries might be foreign investment diversion to China. As Table 1 shows, the shares of FDI flows into the ten ASEAN member countries substantially declined during the two sub-periods, and this might be attributed to China's mounting attractiveness for foreign direct investment (Chantasaswat et al., 2003, 2005). Using data for eight East and Southeast Asian countries,[14] (Chantasaswat et al., 2003) show that the level of the People's Republic of China's FDI is negatively related to the levels of FDI flows to East and Southeast Asian economies, suggesting that the emergence of China has crowded out FDI from Asian economies.[15]

Table 1: FDI Inflows into ASEAN Member Countries as a Percentage of FDI Inflows into Developing Economies, 1990-2004

Economy	1990-1993	1994-1996	1997-2000	2001-2004
Brunei Darussalam	0.01	0.34	0.30	0.64
Cambodia	*0.04*	*0.14*	*0.09*	*0.06*
Indonesia	3.07	3.45	-0.23	-0.19
Lao PDR	0.03	0.08	0.03	0.01
Malaysia	8.49	4.83	1.94	1.35
Myanmar	0.34	0.28	0.24	0.11
Philippines	1.51	1.25	0.75	0.36
Singapore	8.40	8.13	6.28	5.98
Thailand	4.15	1.58	2.41	1.02
Vietnam	0.95	1.51	0.82	0.69
ASEAN10	27.00	21.59	12.63	10.03

Source: UNCTAD, Handbook of Statistics, 2005, New York and Geneva: United Nations and UNCTAD database online: htpp:/stats.unctad.org

3. Cambodia's Foreign Direct Investment by Geographic Origin

Following the UN-sponsored election in 1993 and the opening-up policy towards foreign investment and trade, inward FDI approved by the Cambodian Investment Board, increased substantially from $US 288.55 million in fixed assets in 1994 to $US 1,979 in 1995 and then dropped sharply to $US 663 million in 1996. The sharp increase in 1995 was due to a large investment project of $US 1,300 million from Malaysia (CIB, 2005).[16] As shown in Figure 2, FDI inflows into the country declined gradually after 1995 and reached the lowest level in 2003. However, the inflows somewhat revived in 2004 and moved up to $US 801 million in 2005, according to the most recent data from CIB.

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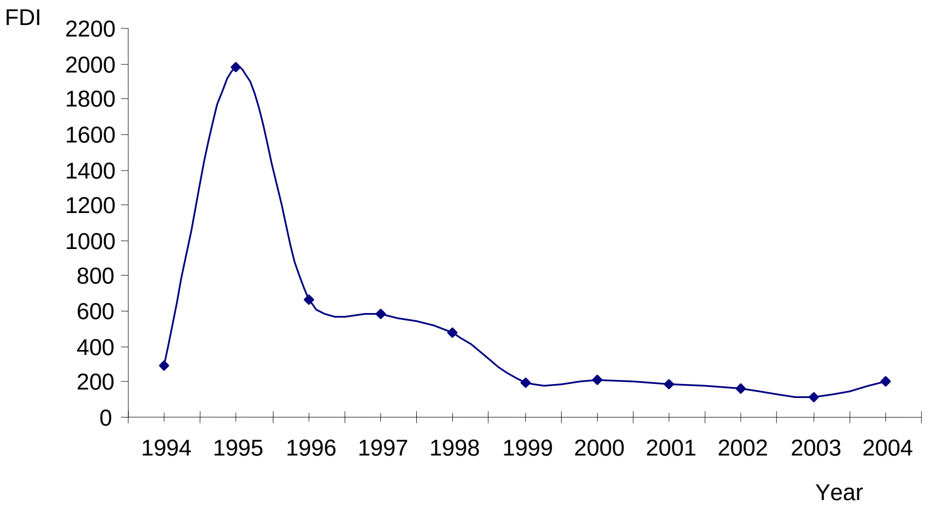
[13] Dollars became the major currency used in daily business transactions while the national currency, Riel, is used mainly for very small transactions, especially in the rural areas of Cambodia (Kang, 2005).

[14] East and Southeast Asian economies include Hong Kong, Taiwan, Korea, Singapore, Malaysia, the Philippines, Indonesia, and Thailand.

[15] In contrast, using augmented gravity models, more recent studies do not find support for the claims that Mainland China has diverted FDI from its Asian developing countries (Liu, et al., 2007; Eichengreen and Tong, 2007).

[16] See endnote 2.

Figure 2: FDI inflows into Cambodia ($US million), 1994-2004



Source: Computed from unpublished data from CIB

As already mentioned Cambodia has mainly attracted FDI from ASEAN member nations. From 1994 to 2004, with more than one third of the total inward FDI Malaysia was the leading source of investment in Cambodia (Table 2). However, in more recent years Malaysia has been surpassed by China as the dominant country of origin. Malaysia's investment in fixed assets in Cambodia went up from $US 0.09 million in 2002 to 8.42 and 38.67 in 2003 and 2004 (Cambodian Investment Board, 2005), while China's investment in fixed assets in Cambodia increased from $US 24 to 33.05 and 88.68 million during the same years. If this surge continues, the cumulative FDI inflows from China will top Malaysia's in the coming years.

Concentrating on the longer period 1994-2004, might somewhat hide the most recent developments, particularly the "China factor". There was a sharp decrease of total inward FDI in Cambodia during 2002-2003 although FDI from China increased in the same period.[17] This is surprising, because, after China's admission to the World Trade Organization in 2001, China was able to export directly to the previously by quta protected markets of the United States, the European Union and other lucrative markets and no longer needed Cambodia or some other Southeast Asian countries as an export platform in the garment and textile sector. Companies which initially intended to invest in Cambodia, may well have considered investing in China instead. That Chinese FDI continued to expand in Cambodia, therefore was due to other factors.

Table 2 shows FDI inflows into Cambodia by regional grouping as well as individual economies from 1994 to 2004. The largest share of FDI in Cambodia came from ASEAN member nations, representing almost half (48 percent) of total inward FDI in fixed assets during this period. 'Greater China' was the

[17] Some authors argue that the motivation for China's rapid and expanding investment in Southeast Asia, e.g. Cambodia, may be due to some political rather than economic factors. These political factors include the establishment of formal diplomatic relations between China and Cambodia and the building up of regional alliances to counter US influences (Frost et al. 2002).

second largest source of Cambodia's inward FDI with more than a quarter (26.7%) of fixed assets during the same period. Although Cambodia's inward FDI from China increased over the period under consideration (Figure 3), the diversion of Cambodia's foreign direct investment from other countries to China can be more than offset by the increase of FDI from China in Cambodia. This effect presents a major concern for Cambodia as it depends very heavily on foreign exchange injected by foreign investors for its economic development. The FDI diversion can result from interrelations between trade/export diversions. The negative effect of FDI diversion on the Cambodian economy is especially serious if Chinese FDI in the country is export oriented. Cuyvers et al. (2008) show that China's accession into the World Trade Organization has deterred FDI flows into Cambodia.[18]

In contrast to the large share of inward FDI from ASEAN member countries,[19] FDI inflows from developed countries such as the United States, the European Union, Canada, and Japan were much smaller and reached 8.4%, 6.9%, 2.1%, and 0.4%, respectively.

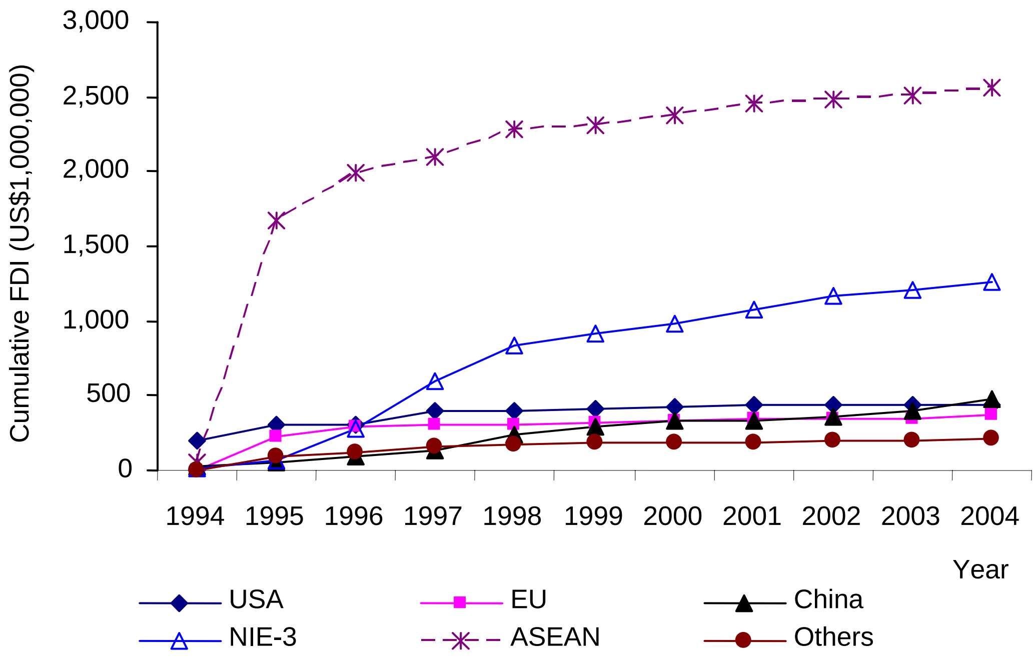
Table 2: Foreign Direct Investment in Cambodia by Country of Origin, 1994-2004

Economy	No. of Projects	% No. of Projects	Fixed Assets (US$1,000)	% of Fixed Assets
ASEAN	*288*	*25.1*	*2,557,336*	*48.14*
Malaysia	108	9.42	1,959,878	36.89
Singapore	97	8.46	284,801	5.36
Thailand	59	5.14	224,347	4.22
Indonesia	16	1.39	61,597	1.16
Vietnam	6	0.52	25,373	0.48
Philippines	2	0.17	1,340	0.03
Greater China	*550*	*47.94*	*1,418,301*	*26.70*
Taiwan	219	19.09	655,607	12.34
China	208	18.13	481,600	9.07
Hong Kong	123	10.72	281,094	5.29
United States	52	4.53	444,638	8.37
European Union	*99*	*8.62*	*366,608*	*6.90*
France	35	3.05	214,820	4.04
United Kingdom	49	4.27	118,970	2.24
Portugal	9	0.78	15,561	0.29
Netherlands	3	0.26	15,166	0.29
Belgium	1	0.09	1,860	0.04
Germany	2	0.17	231	--
Korea	62	5.41	318,134	5.99
Canada	22	1.92	111,971	2.11
Australia	34	2.96	40,765	0.77
Japan	13	1.13	20,308	0.38
Argentina	1	0.09	245	--
New Zealand	1	0.09	11	--
Others	25	2.18	34,227	0.64
Total	1,147	100.00	5,312,544	100.00

Source: Calculated from unpublished data of approved FDI, Cambodian Investment Board

[18] A number of empirical papers found evidence that the rise of China, in fact, stimulated investments in its Asian neighbours (Zhou and Lall, 2005; Eichengreen and Tong, 2007; Liu et al., 2007). This may be due to the emergence of China, leading to an increase of China's demand for raw materials from other countries. Therefore, a country endowed with resources may be attractive to China's investment. However, none of these studies included Cambodia in their calculations.

Figure 3: FDI Stock in Fixed Assets by Country of Origin*, 1994-2004



*Note: FDI stock is approximated by cumulative FDI in fixed assets; NIE-3 refers to Republic of Korea, Hong Kong, and Taiwan; EU includes Belgium, France, Germany, Netherlands, Portugal, and the United Kingdom as investing countries.

Source: Calculated from CIB's Cambodian Investment Statistics, 1994-2004

4. Types of Foreign Direct Investment in Cambodia

Table 3 presents the modes of entry of FDI into Cambodia. Basically, FDI inflows into the country can take the form either of Cambodian-foreign joint ventures or wholly foreign owned enterprises.[20] Cambodian-foreign joint ventures were the most popular mode of entry at the beginning of the government's liberalization policy in 1994. Yet, the investment amounts involved have systematically declined since then. During the period 1994-1997, cumulative FDI in wholly owned enterprises surpassed the Cambodian-foreign joint ventures (in terms of employment about 110,000 compared to 150,000) and became the preferred entry mode by foreign investors. After 1998, annual investment in wholly owned foreign businesses continued to be larger than in Cambodian-foreign joint venture projects.

[19] The ASEAN member countries investing in Cambodia include Malaysia, Indonesia, Singapore, the Philippines, Thailand, and Vietnam.
[20] Wholly foreign owned enterprises include investment projects owned by only one foreign investor and those by multiple foreign investors.

Table 3: Approved FDI in Fixed Assets and Employment by Type of Investment, 1994-2004

Year	Cambodia-Foreign Joint Ventures		Wholly Foreign Owned Enterprises	
	Fixed Assets (US$ millions)	Employment	Fixed Assets (US$ millions)	Employment
1994	501.47	11,611	19.96	9,993
1995	481.32	20,564	1,669.94	33,635
1996	337.55	29,498	426.04	31,351
1997	378.09	51,418	295.57	72,080
1998	338.97	26,297	397.21	63,380
1999	127.66	15,659	131.42	41,257
2000	73.98	12,427	159.71	41,570
2001	27.92	4,172	163.34	22,175
2002	30.80	2,059	138.94	21,108
2003	42.56	5,649	91.20	30,090
2004	42.99	5,640	173.02	72,128
Total	2,383.31	184,994	3,666.34	438,767

Source: Calculated from unpublished data, Cambodian Investment Board

The distribution of the types of foreign investment in Cambodia during 1994-2004 and the initial preference for Cambodian-foreign joint ventures is illustrated in Table 4. There are indeed a number of factors that might encourage MNEs to seek out local partners (Blomström, et al., 2000). First, foreign investors will select local partners when they lack familiarity with the way of doing business in the host country and are afraid of being insufficiently familiar with some important local business characteristics such as, e.g., the availability of reliable suppliers, and the interpretations of the investment and labour laws. Foreign investors may also be interested in the firm-specific assets of the potential local partners such as knowledge of domestic marketing and production conditions. Secondly, MNEs may also opt for a domestic firm as business partner if they perceive, or hope for more preferential treatment by the host country's government when they link up with domestic investors. Thirdly, some foreign investors are risk averse, and look for a domestic partner for risk-sharing purposes especially in developing countries as some investment projects might be rather problematic. Moreover, MNEs may hesitate to enter large foreign markets alone if the investment project requires many resources for the development of local sales networks, after-sales services, etc.

Cambodian-foreign joint ventures were already out of favour with foreign investors in 1995—less than a year after the country liberalized its investment policy. In 1995, the share of wholly foreign owned enterprises sharply increased from 0.33% in 1994 to 27.60% in 1995.[21] While the share of Cambodian-foreign joint ventures further declined, the wholly foreign owned enterprises became systematically more popular during the whole period under consideration, except in 1997.[22] This

[21] This sharp increase was due to an approval of a big investment project from Malaysia.

[22] During that year, an armed conflict between the two ruling parties—CPP and FUNCINPEC—broke out in the centre of the capital city, and most certainly scared away some potential and existing foreign investors.

implies that, other things being equal, MNEs preferred to enter into a small country such as Cambodia on its own rather than seek out a partner for a joint venture (Table 4), and clearly indicates that the reasons to opt for joint ventures are not applicable to Cambodia. The lack of experienced partners in a newly liberalising and transition economy was probably the dominating factor for this.

Table 4: Approved Inward FDI in Fixed Assets by Type of Investment, 1994-2004

Year	Cambodian-Foreign Joint Ventures		Wholly Foreign Owned Enterprises	
	% of No. Projects	% of Total Fixed Assets	% of No. Projects	% of Total Fixed Assets
1994	1.91	8.29	1.31	0.33
1995	6.73	7.96	7.93	27.60
1996	8.43	5.58	7.83	7.04
1997	7.73	6.25	11.55	4.89
1998	3.82	5.60	8.43	6.57
1999	3.51	2.11	4.42	2.17
2000	2.01	1.22	6.33	2.64
2001	1.10	0.46	2.71	2.70
2002	0.60	0.51	2.81	2.30
2003	1.41	0.70	3.31	1.51
2004	1.00	0.71	5.12	2.86
Total	38.25	39.40	61.75	60.60

Source: Calculated from unpublished data, Cambodian Investment Board, 1994-2004

Yet, the foreign investors' preferences for wholly foreign owned enterprises might also be linked to the lack of international arbitration and/or credibility of the Cambodian legal system in case of a business disputes, which are more likely to arise in joint ventures.[23]

A recent survey carried out by the World Bank (2004) and Chap (2005) identifies corruption as the major constraint to the operations of firms in Cambodia, and finds that the fifth highest ranking constraint relates to the legal system and formal conflict resolution. Similarly, a more recent study "Assessment on Corruption in Cambodia's Private Sector" by the Economic Institute of Cambodia (EIC, 2006) indicates that corruption is the most problematic factor for doing business in the country. Additionally, in a firm-level field survey of 164 garment companies operating in 2003 in Cambodia,[24] Yamagata (2006) also found that about 90% of the surveyed companies admitted that "speed money" to government officers was inevitable to allow procurement to go smoothly. This is confirmed by Transparency International (2007) which ranked Cambodia in the top quintile of countries most affected by bribery. According to the 'Global Corruption Barometer 2007', almost three quarters (72 %)

[23] Any dispute relating to a promoted investment established in Cambodia should be settled through consultation between the disputing parties. In case of failure to reach a settlement within two months, the dispute shall be brought by either party for consultation before the Council for opinion or referring the matter to the court of Cambodia or to any international rules (Investment Law, 1994).

[24] This sample size represented 84 percent of total garment firms registered with the Garment Manufacturers Association in Cambodia—the only association of garment manufacturers in the country.

of the respondents declared to have paid bribes to obtain services. This is more than twice as high as the score for other ASEAN countries such as Indonesia (31%) and the Philippines (32%) and more than three times higher than the average for the Asia-Pacific countries.

5. Sectoral Distribution of Cambodia's Foreign Direct Investment

The sectoral distribution of FDI in the Cambodian economy over the period 1994- 2004 shows a very uneven pattern, and is likely due to the higher competitive advantages that some sectors might enjoy. Porter (1990) has indicated that the international success of a nation's industry lies in four attributes, or national "diamond": factor conditions, demand conditions, related and supporting industries and local company rivalry. However, less-developed economies/developing countries are less likely to possess all of these factors (see further).[25]

During the period under consideration, light industries on the one hand, particularly the garment and textile sectors and on the other hand hotels & restaurants have been the most successful in attracting inward FDI into Cambodia. Foreign investment in the garment sector can undoubtedly be partly attributed to the Most Favoured Nation (MFN) status that was granted to the Kingdom of Cambodia by the United States and the decision by the European Union and other developed countries to accept Cambodia as a beneficiary of their Generalized System of Preferences (GSP).

The development of Cambodia's garment and textile industry started in the mid-1990s when garment producers from other Asian countries, such as Malaysia, China, Taiwan, Hong Kong, Singapore, and South-Korea, took advantage of the country's quota-free access to developed country markets. A large reserve of unskilled labour capable of producing garments for exports and the fact that the garment exports of other more developed Asian countries, e.g. China, became quota-constrained, strongly facilitated this expansion (Bargawi, 2005).[26] Consequently, Cambodia's inward FDI in the garment industry used the country as an export platform to bypass quotas and tariffs imposed by the United States and the European Union. Of course, the success in attracting inward FDI into the garment and textile industries was also due to Cambodia being relatively well endowed with natural resources such as cheap land and its low-wage workers having the necessary skills to work in labour-intensive production processes such as garments and textiles.

USAID (2005) and Yamagata (2006) found that almost all garment companies in Cambodia were owned by foreign investors, while only 5 percent belonged to Cambodians. Most of the cloth, the raw material for the production of garments, is imported from other Asian countries—China, Hong Kong, and Taiwan. Also, the garment factories in Cambodia only perform cut-make-and-trim activities, which

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[25] A more detailed discussion of the application of Porter's diamond concept to the situation in Cambodia is provided in Section 9.

[26] Bargawi (2005) argues that the main reason for the emergence of the garment industry in Cambodia in the mid-1990s is attributable to quotas imposed by the USA on some Asian garment exporters, particularly China, who then launched their quota-jumping investment in Cambodia with no quota restriction. According to this reasoning, the low wage rate in Cambodia is a secondary factor encouraging inward FDI into the country.

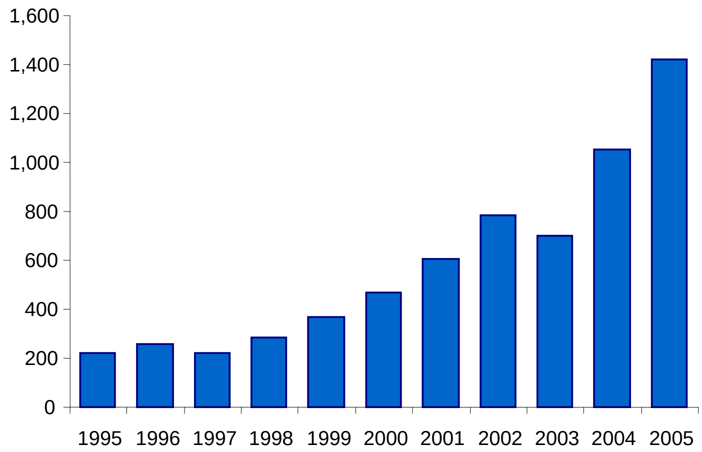
means that value added to the finished products of garments is relatively small (EIC, 2007). This implies that most of Cambodia's inward FDI in the garment industry can be considered as third party market-seeking FDI that uses Cambodia as an export platform to access rich markets (Freeman, 2002).

Based on data from from a field survey (Yamagata, 2006) of 164 garment companies in Cambodia in 2002, it was found that almost all garments are exported. Cambodia sold, no less than 98 percent of the garments produced in 2002, abroad. Most of those exports most went to the markets in North America and the European Union. Similarly, a study by USAID (2005) confirmed these findings by indicating that all of Cambodia's garment production was indeed exported. Two thirds of those exports ended up in the US and most of the rest found its way to EU markets.

The second most important sector for foreign investors in Cambodia is the service sector, which attracted almost half (45.6 percent) of total realized inward FDI in fixed assets during 1994-2004. Within services, the sub-sectors hotels and restaurants (43 per cent), and the transportation sector (34 per cent) together received more than three quarters (77 per cent). The popularity of these service sectors for foreigners is the direct result of Cambodia's exceptionally rich cultural heritage and its impressive historical sites, especially the world-famous Angkor Wat temple complex. Also the government's "open-air" policy, which allows direct international flights to the city of Siem Reap, where the Angkor Wat shrine and the other temples are located, plays an important role. According to Porter's diamond model, hotels & restaurants and the transportation sector can be considered as 'supporting sectors' for the tourism industry, which encourages other investment in these sectors.

Thanks to Cambodia's cultural heritage and the Angkor Wat temple site as well as increasing political stability, the country has become a much favoured destination for international tourists. The estimated total of tourist arrivals in Cambodia averaged 581 thousand visitors between 1995 and 2005, with an annual growth rate of about 22 percent during those years (Figure 4). However, the growth rates of tourist arrivals for the years 1995, 1997 and 2003 were negative. The decline in visitors to Cambodia can be explained by the uncertainty surrounding the country's political situation in these specific years as a result of the factional fighting between the CPP and FUNCINPEC political parties and the election years of 1997 and 2003, respectively.

Figure 4: Visitor Arrivals in Cambodia (in thousands), 1995-2005



Source: Statistical Yearbook 2006, Ministry of Planning.

Although the government encouraged FDI into agriculture and the agro-industry, the cumulative FDI in these sectors only amounted to 5 percent of the total (Table 5). The low level of FDI in agriculture is probably partly due to such adverse factors as land tenure (a non-resolved problem in Cambodia), administrative barriers, security and crime, and the shortage of irrigation systems (Hing, 2003, 2006), as well as Cambodia's small domestic market for agricultural products and the protectionist measures in developed countries for their own agricultural production.

FDI is concentrated primarily in the labour-intensive sectors rather than the relatively more capital-intensive industries such as construction (Table 5). Garments and textile textiles, which use labour more intensively in the production process, have been particularly attractive for FDI. The combined share of realized FDI in fixed assets in garments and textiles amounted to almost 30 percent of total inward FDI in the country. The resource-based, more capital-intensive hotel & restaurant sector attracted about 20 percent during the same period. The share of FDI in the more capital-intensive construction and transportation sectors is a negligible 0.3% and 0.2%, respectively, in spite of the Government's efforts to encourage FDI in infrastructure. To build the country's infrastructure after the destruction during the many years of civil war and political upheaval is essential for Cambodia's further development.

Table 5: Sectoral Distribution of Realized FDI in Cambodia, 1994-2004

Sector	No. of Projects	% of No. of Projects	Realized FDI (US$ Million)	% of Total Realized FDI
AGRICULTURE AND FISHERIES	*11*	*2.32*	*101.87*	*5.13*
Agriculture and related activities	10	2.11	99.41	5.01
Fishing	1	0.21	2.46	0.12
INDUSTRY	*406*	*85.83*	*941.59*	*47.42*
Food products and beverages	15	3.17	60.57	3.05
Tobacco	5	1.06	32.79	1.65
Textiles	10	2.11	72.32	3.64
Garments	298	63.00	506.53	25.51
Tanning and dressing of leather, manufacture of luggage, handbags, saddlery, harness and footwear	23	4.86	40.28	2.03
Paper and paper products	9	1.90	9.24	0.47
Coke, refined petroleum products and nuclear fuel	1	0.21	0.10	0.01
Chemicals and chemical products	1	0.21	0.47	0.02
Rubber and plastics products	7	1.48	7.79	0.39
Other non-metallic mineral products	7	1.48	18.71	0.94
Fabricated metal products, except machinery and equipment	6	1.27	7.47	0.38
Radio, television and communication equipment and apparatus	1	0.21	0.73	0.04
Medical, precision and optical instruments, watches and clocks	5	1.06	11.53	0.58
Motor vehicles, trailers and semi-trailers	4	0.85	6.64	0.33
Furniture	7	1.48	79.89	4.02
Recycling	1	0.21	2.95	0.15
Electricity, gas, steam, and hot water supply	5	1.06	77.58	3.91
Construction	1	0.21	6.00	0.30
SERVICES	*51*	*10.78*	*905.34*	*45.58*
Sale, maintenance and repair of motor vehicles and motorcycles	3	0.63	3.95	0.20
Hotels and restaurants	25	5.29	388.46	19.56
Land transport	1	0.21	4.25	0.21
Transport activities, activities of travel agencies	9	1.90	307.02	15.46
Post and Telecommunication	5	1.06	46.76	2.35
Education	2	0.42	98.35	4.95
Recreational, cultural and sporting activities	6	1.27	56.55	2.85
OTHER BUSINESS ACTIVITIES	*5*	*1.06*	*37.10*	*1.87*
Total	**473**	**100.00**	**1,985.90**	**100**

Source: Calculated from unpublished data, Cambodian Investment Board

6. Provincial Distribution of Foreign Direct Investment in Cambodia

Cambodia covers an area of 181,035 square kilometers and consists of twenty-two provinces and two major cities for which the data are often published separately.[27] The distribution of FDI in the Kingdom over these provinces and cities is extremely uneven (Table 6). Only 16 provinces succeeded in attracting foreign-invested projects.[28] Phnom Penh, the capital city of Cambodia, has been by far the most successful in convincing foreign investors to locate there as it reached about three quarters (77 percent) of total inward FDI measured both in fixed assets and employment. Phnom Penh City and its surrounding province Kandal taken together receive 82 per cent of the country's FDI in terms of fixed asserts and 92 per cent of the total employment in foreign controlled firms. Shihanoukville comes in second position, with only about 8 and 4 per cent of total FDI during 1994-2004 measured respectively in fixed assets and employment, (Cuyvers, Soeng and Van Den Bulcke, 2006). Evidently, compared to the rest of the country, Phnom Penh has more to offer foreign investors with respect to access to communication networks, transportation facilities, infrastructure, business-related services and the availability of technical and managerial personnel.

The geographical concentration of inward FDI in Cambodia also results from agglomeration effects caused by investors following others in the choices of their investment locations (Fujita et al., 1999). There are benefits for firms to be located close to each other and forming industrial clusters, thus giving rise to spill-over effects, specialization of factors of production and forward and backward linkages (Navaretti and Venables, 2004). The highly geographical concentration of the country's inward FDI is clearly the result of location advantages. For instance, the concentration of hotel & restaurant businesses in the Siem Reap province is mainly due to the province's world-famous tourist attractions, as well as to industrial clustering in transportation and other service activities.

Although the government has promoted Special Promotion Zones[29] in the provinces of coastal Sihanouk Ville, coastal Koh Kong (bordering Thailand), Poipet (town of Bantey Meanchey bordering Thailand), and Svay Rieng and Takeo (bordering Vietnam), these provinces virtually attracted almost no FDI, except Sihanouk Ville—the second city of the Kingdom. Through location advantages such as the vicinity of an international seaport, the relatively better infrastructure, tourist attractions and basic services, Sihanouk Ville managed to attract some inward FDI. However, this amounted to only 1.6 % of the total employment created by FDI inflows into Cambodia.

The highly uneven distribution of Cambodia's foreign direct investment is also related to the scarcity of technical and managerial personnel in the provinces, and the fact that people residing in Phnom Penh

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[27] Banteay Meanchey, Battambang, Kampong Cham, Kampong Chhnang, Kampong Speu, Kampong Thom, Kampot, Kandal, Kep, Koh Kong, Kratie, Mondolkiri, Oddar Meanchey, Pailin, Phnom Penh, Preah Vihear, Prey Veng, Pursat, Ratanakiri, Siem Reap, Sihanoukville/Kampong Som, Stung Treng, Svay Rieng, and Takeo. Kep is in Kampot province. However, FDI for Kep and for Kampot are separated by CIB/CDC.

[28] Some provinces such as Kampong Chhnang, Kratie, Mondolkiri, Oddar Meanchey, Pailin (formerly part of Battambang Province), Preah Vihear, Prey Veng, or Stung Treng did not manage to attract any FDI during 1994-2004.

[29] Personal e-mail correspondence with the Deputy Director of the Project Monitoring Department, Cambodian Investment Board, Council for the Development of Cambodia.

are rarely willing to work elsewhere in the country, because of the poor infrastructure, difficult transportation and shortages of basic services such as potable water in the more remote locations.[30]

This extremely uneven distribution of FDI in Cambodia and of the ensuing job creation is expected to widen the divide between the rich and the poor even more, in spite of its recent impressive two digits economic growth (Sok, 2005; Ballard, 2007). In the rural areas, the poverty rate is about four times as high as in the capital city Phnom Penh (Sok, 2005).[31] This widening gap between the rich and the poor may cause destabilization as a result of increased migration, social pressures and rising criminality. As a consequence, poor unskilled workers (both women and men) from more remote provinces are moving to the urban areas, especially Phnom Penh, or to Thailand, to look for work because of the absence of livelihood alternatives in their villages. Migrant workers are reportedly at high risks of being confronted with cheating/exploitation, beating, rape/abuse, and security hazards (So et al., 2007).

Table 6: Provincial Distribution of Approved Inward FDI in Cambodia, 1994-2004

Province	No. of Projects	% of No. Projects	Fixed Assets (US$ millions)	% of Fixed Assets	Employment	% Employment
Bantey Meanchey	4	0.40	46.01	0.76	901	0.14
Battambang	2	0.20	9.93	0.16	484	0.08
Kampong Cham	11	1.10	47.52	0.78	4,592	0.74
Kompong Speu	13	1.30	112.41	1.86	9,912	1.59
Kompong Tom	1	0.10	2.58	0.04	105	0.02
Kompot	6	0.60	208.77	3.45	1,437	0.23
Kandal	134	13.43	305.06	5.04	90,079	14.44
Kep	1	0.10	1.03	0.02	25	--
Koh Kong	6	0.60	50.91	0.84	1,144	0.18
Phnom Penh	757	75.85	4,652.07	76.81	483,818	77.56
Pursat	2	0.20	2.24	0.04	327	0.05
Rattanakiri	2	0.20	14.10	0.23	1,805	0.29
Siem Reap	15	1.50	138.97	2.29	3,003	0.48
Sihanoukville	42	4.21	463.86	7.66	24,023	3.85
Svay Rieng	1	0.10	0.18	--	952	0.15
Takeo	1	0.10	1.05	0.02	1,154	0.19
Total	998	100.00	6,056.68	100.00	623,761	100.00

Source: Computed from unpublished data, Cambodian Investment Board

[30] In some provinces in Cambodia, people face a shortage of drinking water due to drought. For instance, cattle died because of lack of water in the remote areas of the Kompong Speu province (Radio Free Asia, 2005).

[31] The Cambodian government defines the poverty line as the sum of the minimum food and non-food expenditure. The "food poverty" line per capita per day is 2,100 Kcal, and the "non-food poverty" line per person per day is 2,470 Riels for Phnom Penh, 2,093 Riels for the provincial capitals, and 1,777 Riels for the rural areas (the Riel is the national currency in Cambodia). The population under the poverty line is defined as poor and represents 36 % of the population (Head count index) in 1999. (Japan Bank for International Cooperation, 2001, accessed at http://www.jbic.go.jp/english/oec/environ/poverty/pdf/cambodia_e.pdf).

7. Approved versus Realized FDI: a comparison

Table 8 shows realized inward FDI by type of investment from 1994 to 2004, as opposed to approved FDI depicted in Table 3. In 1994 only 5.8 % of the approved capital for Cambodian-foreign joint ventures was actually invested as compared to 16.5% for wholly foreign owned enterprises. Because important time lags between the year of project approval and the actual investment, both measures should be compared from a longer time perspective. On average the realized FDI in fixed assets as a percentage of approved FDI for Cambodian-foreign joint ventures and wholly foreign owned enterprises was 29 % and 35 %, respectively over the period 1994-2004. However, this discrepancy is mainly due to the period before 2000. More recently the diiferences in the ratio between approved and realized inverment strongly diminished.

The low proportion of realized FDI to approved FDI may partly be explained by investors having inflated their amount of investment as declared in the application form in order to bargain and obtain better or higher incentives. It is indeed government policy to grant larger incentives the higher is the amount of investment (Chap, 2005). Chap (2005) also argued that middlemen who have close connections with (corrupt) government officials successfully obtained investment licenses and concessions that were then sold to potential investors in order to make profits. If investment project “buyers” were not found, the projects were delayed or cancelled. A number of firm-level surveys about the importance of the investment climate listed several negative factors, e.g. corruption, poor infrastructure, high cost of electricity, weak legal and judiciary systems, which increase the cost of doing business in Cambodia (Hagemann, 2002; World Bank, 2004; ADB, 2006). However, this situation seems to improve gradually. The proportion of realized to approved FDI, although often oscillating, shows an upward trend over the period under consideration and even reached a very high ratio in 2003 and 2004 – even 100 percent—for each type of ownership.

The non-realization or delayed realization of approved projects might also be due to changes in the international environment. A factor that might have had a negative impact on the ratio of realized to the approved FDI in Cambodia are the earlier mentioned Asian crisis of 1997 and China’s accession to the World Trade Organization in 2001. First, for both wholly owned subsidiaries and joint ventures, evidence shows a severe decrease in this ratio in terms of capital investment in 1997. This was probably due to the cancellation or delay in the planned investment, and a rapid pick up, in particular, for wholly foreign owned investment in 1999-2000. Secondly, while it might be interesting to speculate about the role of the China’s WTO accession on the drop in the capital investment realization ratio for wholly foreign owned enterprises in 2001-2002, and the subsequent rise of this ratio in 2003-2004, this is difficult without a more detailed study.

The employment realization ratios mostly reach a higher level than the capital investment realization ratios. This means that some realized FDI projects must have used more labour intensive production processes than initially planned. As the data include both approved and realized investment projects during 1994-2004,[32] it is likely that especially the expanded projects are relying more on Cambodia's cheap, abundant labour, while keeping the use of capital relatively constant.

Table 7: Realized FDI by Type of Investment, 1994-2004

Year	Cambodian-Foreign Joint Ventures		Wholly Foreign Owned Enterprises	
	Fixed Assets (US$ million)	Employment	Fixed Assets (US$ million)	Employment
1994	29.20	3,440	3.71	7,017
1995	282.58	4,200	288.75	24,957
1996	125.92	9,775	157.13	11,418
1997	30.95	13,398	77.44	33,765
1998	37.98	12,577	129.65	35,394
1999	46.59	6,515	92.13	25,893
2000	24.74	7,831	147.11	37,313
2001	22.95	2,638	111.31	22,043
2002	14.05	1,863	46.27	20,428
2003	37.56	5,619	65.18	27,700
2004	42.99	5,640	171.72	71,072
Total	695.51	73,496	1,290.38	317,000

Source: Calculated from unpublished data, Cambodian Investment Board

Table 8: Realized FDI as percentages of approved FDI by type of investment in Cambodia, 1994-2004

Year	Cambodian-Foreign Joint Ventures		Wholly Foreign Owned Enterprises	
	Fixed Assets	Employment	Fixed Assets	Employment
1994	5.82	29.63	18.58	70.22
1995	58.71	20.42	17.29	74.20
1996	37.31	33.14	36.88	36.42
1997	8.19	26.06	26.20	46.84
1998	11.20	47.83	32.64	55.84
1999	36.50	41.61	70.10	62.76
2000	33.44	63.02	92.11	89.76
2001	82.20	63.23	68.14	99.40
2002	45.62	90.48	33.30	96.78
2003	88.25	99.47	71.47	92.06
2004	100.00	100.00	99.25	98.54
1994-2004	29.18	39.73	35.20	72.25

Source: Calculated from unpublished data, Cambodian Investment Board

[32] Expanded investments are included in the active investment projects, and no separate data on expanded investment projects are available (Project Evaluating Department, CDC).

8. The role of Foreign Direct Investment in Cambodia's economic development

There has been an intensive debate on the role of FDI in economic development in recipient countries, especially in developing economies. The entry of MNEs may produce both a positive and a negative impact on the host country (Lall 1995). For example, more competition brought about by FDI activities may induce local firms to become more efficient and may provide spill-overs in skill management techniques or technical knowledge. However, the presence of foreign firms may also drive indigenous firm out of business due to strong competition or unfair practices.

Although there are also costs associated with inward FDI, it is generally agreed that it brings into the recipient countries badly needed capital, new forms of technology, superior managerial skills, and international marketing techniques, all of which are often referred to as spill-over effects and externalities. In most cases, FDI transfers are not limited to the inflow of productive capital and managerial skills, but also include embodied and tacit knowledge and technology (Wei, 2003). FDI activities create job opportunities and skill-upgrading of local workers, and can reinforce export competitiveness of the host country. The impact of inward FDI for the host country ranges from economic effects (e.g. productivity increases, employment creation, trade links, poverty reduction) to more general effects (such as those on society, politics and the environment) (see e.g., Ietto-Gillies, 2005). Hereafter the focus is however on a conceptual discussion of the economic effects of FDI.

8.1 FDI and Technology Transfers

FDI may raise the productivity of domestically owned firms by improving resource allocation or by putting competitive pressure on local firms to imitate, to innovate or to produce at higher levels of technical efficiency (Leibenstein, 1966; Li et al., 2001; Wei, 2003). The presence of MNEs may help to speed up the process of the technology transfer and lower the cost of such transfers. Imitation, demonstration and contagion effects, along with increased mobility of employees from multinational subsidiaries to domestically-owned firms may form additional routes for inducing transfers of technology. Also employees trained by foreign firms may decide to start their own business at a later stage in their career, thereby increasing entrepreneurship in the host country.

Studies about the technology transfer induced by FDI in Cambodia are extremely scarce. A firm-level survey carried out by Chap (2005) and based on 60 companies indicated that the technology transfers mainly occurred as imports of technology embedded machines and the introduction of foreign management teams. About one quarter of the surveyed firms used only low technology, while almost half employed a medium level of technology and a third relied on a high level of technology (Table 9).[33] An interesting finding is that all surveyed firms provided training to their local personnel, ranging from one week to more than three months, and that a number of trained workers found better jobs or

[33] A low level of technology is defined as the "use of labour or work by hand", while the medium level refers to "semi-computerized and semi-automatic" production processes, and high level is interpreted as "high-tech, automatic and computerized operations."

started up their own businesses. USAID (2005) and Yamagata (2006) also stated that training is often provided to local employees in the export-oriented garment industry, which is largely owned by foreign investors. However, to better assess technology transfers or productivity spillovers from FDI in Cambodia an in-depth analysis of firm-level data is required.

Table 9: Level of technology in a sample of foreign firms in Cambodia

Technological level	Number of Firms	% of Total
Low	14	23
Medium	27	45
High	19	32
Total	60	100

Source: Chap (2005), p. 90

8.2 FDI and International Trade

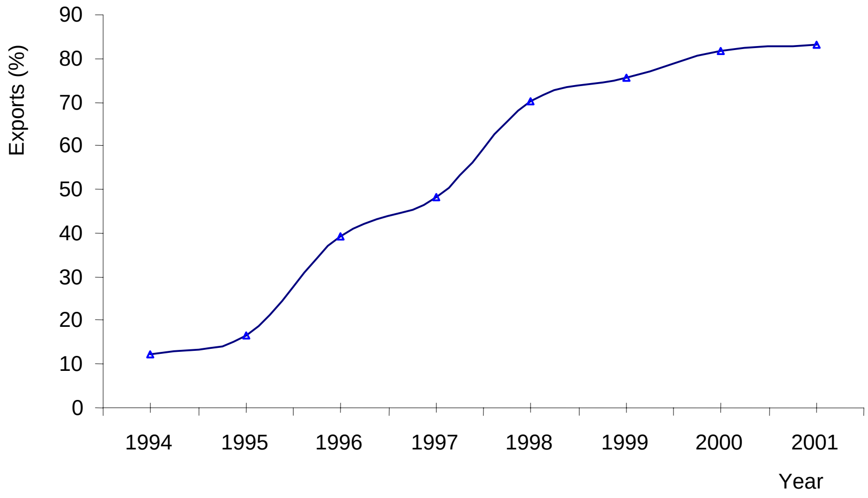
FDI is often believed to positively affect the host country's international trade patterns, and is usually considered as an engine for economic development and growth. If the FDI home country is relatively well endowed with capital while the host country is relatively labour abundant, this implies that the return on capital will be lower in the FDI home country. Therefore, firms from the capital rich country will engage in international production by exporting intermediate inputs and capital intensive services to their foreign affiliates in the labour rich country in return for differentiated finished products (Wei, 2003).

As was indicated above, the majority of FDI in Cambodia is foreign market seeking/ exported oriented FDI,[34] and the garment industry is proportionately attracting most of Cambodia's FDI inflows. Further circumstantial evidence on the impact of FDI can be found in Figure 5, which shows Cambodia's exports by product groups. Following Cambodia's liberalization policy with respect to foreign investment and international trade in 1994, the exports of apparel goods and textiles increased enormously, i.e., from about 12 percent in 1994 to 83 percent in 2001 of Cambodia's total exports of commodity products.

An attempt to investigate the relationship between FDI and international trade in Cambodia was undertaken by Neak (2004). Using a gravity model with panel data on bilateral trade between Cambodia and the FDI home countries, Neak established that FDI had a positive impact on the volume of trade. Another investigation into the FDI-international trade relation at the sector level in Cambodia by Cuyvers, Soeng and Van Den Bulcke (2006) confirmed that FDI is positively related to international trade of the country. Data at the level of the firm or the product should allow to examine the relationship between international trade and FDI even better.

[34] Data on 50 firms are obtained from the Project Monitoring Department, Cambodian Investment Board. On average, the exports of these firms represent more than 90% of their total output.

Figure 5: Exports of garments and textiles as percentage of Cambodia's Total Commodity Exports, 1994-2001



8.3 FDI and Cambodia's Capital Formation

FDI is expected to have a positive effect on a host country's capital formation. FDI can take place either through mergers and acquisitions of existing firms (M&As) or via greenfield establishments. Lall (1995) and Ietto-Gillies (2005, p.26) indicate, however, that because greenfield investments create new production units they are more likely to lead to new productive capacity for the host country's economy. Depending on the restructuring measures that are carried out in case of the take-over of existing firms, an increase in capacity is less certain to occur. However, this distinction is less relevant for Cambodia, as the large majority of foreign subsidiaries are greenfield investments, especially in the manufacturing sector,[35] where it is encouraged by the availability of abundant and cheap land, as well as inexpensive construction workers.

Table 10 presents realized FDI in fixed assets as a percentage of Cambodia's annual total fixed capital formation. Over the years the fixed capital created by FDI inflows ranged between 7 to 51 percent of the country's fixed capital formation. On average, the annual contribution of FDI to the Cambodian capital formation was about 21 percent with a standard deviation of 13 percent over the period 1994-2004. Thus FDI undoubtedly has added to the available fixed capital stock of the country and in turn improved productivity as labour had more capital to work with.

[35] The World Development Report (2000) notes that M&As are rare in both developing economies and economies in transition.

Table 10 : Realized FDI as percentage of Cambodia's Total Capital Formation

Year	Realized FDI in Fixed Assets (US$ millions)	Total Fixed Capital Formation* (US$ millions)	% of FDI in Total Fixed Capital Formation
1994	24.90	323.49	7.70
1995	508.86	987.89	51.51
1996	244.76	689.10	35.52
1997	96.50	558.44	17.28
1998	152.59	539.09	28.31
1999	116.55	678.61	17.18
2000	158.89	828.10	19.19
2001	128.50	760.76	16.89
2002	59.36	862.48	6.88
2003	84.99	923.40	9.20
2004	201.89	1,129.71	17.87

*Total Capital Formation is equal to Realized FDI in fixed assets plus domestic fixed capital formation. Data on domestic fixed capital formation was obtained from the World Development Indicators' CD-ROM (2007).

Source: Cambodian Investment Board and World Development Indicators (2007)

8.4 FDI, employment and poverty reduction

In 2004 the Cambodian labour force was estimated to be about seven and a half million people out of a population of 13.5 million. While in 1994 only 0.17 per cent worked in foreign owned firms, this share went up to 1.74 in 1997, 3.16 in 2001 and reached 5.2 per cent in 2004.

The relationship between FDI and employment has been debated rather extensively in the recent literature (cfr. UNCTAD, 1994; Lall, 1995; UNCTAD, 1999, 2000, 2004, 2006). For example, the World Development Report (1994) acknowledged that MNEs account for about one-fifth of employment in non-agricultural activities in developed countries and some developing economies, implying that MNEs directly contribute to the employment in manufacturing and services. MNEs also indirectly generate employment through several channels (e.g. subcontractors, suppliers and other service enterprises) in the home and host countries. Firms that are vertically linked to MNEs, including sub-contractors, buyers and suppliers, will generally generate a positive effect on employment if the investors increase the demand for local inputs and services, and raise their sales (Lall, 1995). Closer linkages with local suppliers can be an important vehicle for technology diffusion, and skills improvement and for export markets penetration, which increase the volume of trade and generate local employment.

It is generally accepted that FDI is a powerful catalyst for economic growth in developing countries and that economic growth may in turn play an important role in poverty reduction (Zhang, 2006). FDI may have a positive impact on growth due to a number of factors such as FDI-induced enhancement of capital formation and employment augmentation; expansion of manufacturing exports; and technology transfers and spillover effects on locally-owned firms. Based on the belief that FDI helps reduce poverty both directly and indirectly, the governments of developing countries have made great efforts to attract FDI, in addition to their attempts to alleviate poverty. Cambodia is no exception. Of course, for FDI to be successful in reducing poverty, it is necessary to have trickling down effects to the poorest sections of the population.

The growing literature on the positive impact of FDI on employment, which in turn may contribute to reduce poverty in the host country, has inspired a certain amount of research on the linkages, in particular, in developing ASEAN nations. Based on their previous econometric study on the ASEAN region, Mirza and Giroud (2004) established that FDI has been poverty-reducing in the region and that the effect of FDI on poverty reduction has been stronger than elsewhere. Freeman (2004) and Thoburn (2004) have endorsed those findings. More recently Zhang (2006) has used a growth model with Chinese cross-sectional and panel data at the provincial level and found that FDI indeed plays a crucial role in promoting the country's economic growth and therefore poverty reduction. In contrast, after a review of empirical studies, Mold (2004) was not convinced by the available evidence that FDI was an important instrument for poverty reduction.

In Cambodia, manufacturing attracted the lion's share of total inward FDI from 1994 to 2004, with the labour-intensive, export oriented garment industry as the most attractive sector to foreign investors. While the success of the garment industry in terms of FDI attractiveness and the competitiveness of the industry has been explained as the result of the country being the beneficiary of the Multi-Fibre Arrangement (MFA), some authors have pointed out that the garment industry in Cambodia is likely to remain internationally competitive even after the Multi Fiber Agreement is phased out (Bargawi, 2005; Yamagata, 2006, 2007). Cambodia's garment exports might be considered as an example of FDI's positive contribution to poverty reduction, via exports and employment creation. The World Bank (2006) has reported that poverty in Cambodia has fallen by 10-15 percentage points over the period 1994-2004, i.e., during the period that FDI started to flow into the country.

In his field survey of Cambodia's garment companies, Yamagata (2006) has found evidence that the garment industry significantly contributes to poverty reduction in the country, since the industry provides employment at relatively high wages for the Cambodian poor, most of whom come from the underdeveloped rural areas. Yamagata confirmed that the garment industry does not require high levels of education for the workers and that the promotion of the workers to higher skill levels is relatively easy. This means that the garment industry offers the opportunity to earn a higher income, and makes it possible to achieve a higher standard of living.

In a simple regression analysis of time series data with of 9 to 10 observations to investigate the extent to which FDI affected poverty reduction, Hing and Tuot (2007) found that Cambodia's inward FDI is an important source of the country's economic growth and employment generation, but indicate that the impact is limited, and not enough for rapid poverty reduction. However, their results may suffer from the limited number of observations and misspecification problems. Therefore, an econometric study with larger observations and more control variables is needed before more definite conclusions can be drawn.

9. Development of Cambodia's competitive advantages according to Porter's "Diamond"

From Cambodia's example, it is clear that Porter's views on the determinants of the competitive advantage of industries (Porter, 1990) have either to be amended, or otherwise lead to the conclusion that Cambodia's success in attracting FDI, particularly in the garment sector, does not contribute to the building up of the country's competitive advantages. Following the typical facets of Porter's diamond analysis the contribution to the development of Cambodia's competitive advantages will be assessed by looking at the factor conditions, the demand conditions, the local company rivalries and the supporting industries.

Evidently, many of Cambodia's factor conditions offer a solid foundation for the building up of competitive advantage. The vast pool of low-skilled workers, including female workers, has been a very attractive factor for the development of Cambodia's garments and textiles industry. Female workers are preferred in the garment factories in the country and account for a large share of total employment in the industry (Yamagata, 2006). In the case of tourism, the preponderance of a low-skilled labour force can, however, act in a negative way as international or regional tourists expect well-trained personnel and staff in the hotels. However, such negative effects can partly and gradually be offset; however, as more Cambodians may receive on-the-job training (tourist managers, tour guides, chefs, etc.) and enrol in English language courses before being appointed in a job where contact with foreign visitors is essential. Obviously, the old Khmer temple complexes in Siem Reap and in other provinces, the unspoiled beaches at the seaside in Sihanouk Ville and the French colonial buildings in Phnom Penh, major provincial towns and many other historical sites, as "historically produced" factor conditions, are more than balancing the likely disadvantage of Cambodia's tourism sector with respect to its low-skilled labour force. In the garments and textile industry which is, to a large extent, based on the availability of a reserve of cheap unskilled labour.

Local demand in a least developed country can hardly be considered as a factor contributing to the development of competitive advantage. Demand in the sectors that have attracted the bulk of Cambodia's FDI does not emanate from the local market and is basically global demand. This is definitely the case for the sectors of garments and textiles, and also for the tourism and transportation sectors. Yet, in a quickly integrating region such as Southeast and East Asia, also regional demand should be taken into consideration as an important determinant, even though the regional dimension may be somewhat more relevant for tourism than for garments and textiles. However, in the latter case one should not forget the growing role of globalisation and the "slicing up" of the value chain. For Cambodia's garments the major outlet is the vast world market. Cambodia's competitive advantage, according to this factor, derives from its status as a 'Least Developed Country' and the special advantages it receives in the 'Everything but Arms Scheme' and the Generalized System of Preferences of the industrialized countries, which makes the products of Cambodian origin eligible for duty-and quota-free access to these markets, contrary to the same products of, e.g., more developed Asian countries, such as those from China.

In order to illustrate the role of the international market in the development of Cambodia's competitive advantage, the levels and changes over time in Balassa's revealed comparative advantage index (RCA) at sector levels can be used. A comparison with the RCA in other ASEAN countries, which are the natural competitors of Cambodia, reveals that Cambodia has a strong comparative advantage in the garment industry over all individual ASEAN counterparts, Laos-Myanmar-Vietnam, ASEAN-9, and the rest of the world (Cuyvers et al., 2006). In contrast, Cambodia has only a comparative advantage in textile production, relative to Myanmar and Lao PDR from 1992 and 1996 onwards, and it even experiences a comparative disadvantage relative to Vietnam, ASEAN-9 and the rest of the world in this sector. In tourism, Cambodia has a strong comparative advantage over some ASEAN counterparts, Laos-Myanmar-Vietnam, ASEAN-8 and the rest of the world, except Indonesia and Lao PDR. Estimation results of the impact of inward FDI on RCA, total international trade (exports plus imports), exports and imports separately, of the textile, garments and tourism sectors, reported by Cuyvers et al. (2006) for the period 1994-2001, show that a 1% increase in the FDI stock in the garment sector leads to a statistically significant increase of 1.10%, 15.5%, 1.15%, 1.09% in RCA, international trade position, relative exports and relative imports in the sector. Consequently, it can be concluded that inward FDI in the garment sector has had an important impact on overall international trade volumes, but that the net impact on the sector's external trade balance is only slightly positive. This should be kept in mind when the role of supporting industries is discussed. On the other hand, Cuyvers et al. (2006) found no statistically significant impact of changes in the FDI stock in the tourism sector on the sector's RCA, or external service trade volumes, which means that the existing international demand for tourism is not affected by FDI in the sector.

According to Porter (1990), one of the determinants of a national competitive advantage depends on the way in which firms are created and managed, and on domestic rivalry. Domestic rivalry plays an important role in the process of innovation and firms' efficiency for international success. In the case of Cambodia, firms, especially garment companies, were created by "chance events" (Porter, 1990: 124-125). The garment industry developed in Cambodia after quota restrictions were imposed by the United States and other developed countries on garment exports of some other Asian countries, particularly China. The majority of the garment and textile firms in the country are owned by investors from China, Taiwan and Hong Kong. Local rivalry is limited locally, but is fierce with other garment exporters, as Cambodia's garments are highly export oriented (see Cuyvers et al., 2006). Domestic investment in the garment sector has been relatively low, but started to rise gradually in the form of wholly owned companies or joint ventures with foreign investors. The tourism industry shares some similarities with the garments sector, as it started to develop after the national election of 1993 when Cambodia was finally at peace. Both domestic and foreign investment is attracted to the tourist sector as demand for its services comes from both domestic and foreign markets. Local rivalry is likely to be stronger as evidenced by the higher level of investment in the sector by Cambodians. This stimulates service improvement, which in turn creates further factor demand, and positively affects the country's "diamond".

A weak facet of Cambodia's "diamond" seems to be the lack of development of supporting industries. This seems especially true for garments and textiles, where the industrial cluster is lacking important subsectors Activities such as the production of textile machinery, the development and application of design patterns, basic raw materials, etc. remain marginal both in terms of upward and downward initiatives. For instance, most of the cloth for garment production in Cambodia is usually imported from other Asian countries, in particular, China, Hong Kong, and Taiwan. The lack of supporting industries can also be illustrated by the estimation results of Cuyvers et al. (2006), where it was found that a 1% increase in the FDI stock in the garment sector leads to an increase of 1.15% and 1.09% in relative exports and relative imports in the sector, which implies that the net impact on the sector's external trade balance is only slightly positive. Yet, inward FDI in the garment sector has had an important impact on overall international trade volumes (exports and imports) of the sector.

The lack of supporting industries for garments may be partly explained by the fact that both foreign and local investment in the textile sector has been low according to unpublished data from the Cambodian Board of Investment. Infrastructure, especially irrigation systems for agriculture and raw material production, is also underdeveloped. The investment, both local and foreign, in the relatively capitalintensive infrastructure is negligible (Cuyvers, et al. 2006). Here, there is an important role to be played by the Cambodian government in creating a sustainable, competitive advantage for the country. For example, public investment in infrastructure (paving roads, developing irrigation system, etc.) can further influence factor demand and attract more private investment. Government policies to improve the quality of education, to stimulate fair competition, to develop efficient capital markets, and the like, are important for shaping its "diamond." In the tourism cluster there are more linkages (restaurants, passenger transportation, and the government's "open-skies" policy which allows direct international flights to Siem Reap). Moreover, as estimation results by Cuyvers et al. (2006) show, there exist significant and positive effects on revealed comparative advantage, international flows of trade and services and exports, meaning that the local transportation services are substituting for imports of transportation services.[36]

10. Concluding remarks

Cambodia became an attractive destination to foreign direct investment after the Kingdom's first national election of 1993, which resulted in a transformation of centrally-managed socialism, first of the Khmer Rouge regime, then of the Prime Minister Hun Sen-led government, by opening up the Cambodian economy to the rest of the world and globalisation. Inward FDI increased substantially in 1995, but dropped afterwards because of the instability created by the fractional fighting between the ruling political parties, and also because of the indirect negative effects of the Asian economic crisis of 1997, the effect of which is confirmed by Cuyvers et al. (2008).

Although the European Union, the United States and Japan are the largest direct investors at the world level (Zhang, 2005), the major sources of inward foreign direct investment in Cambodia are from ASEAN member nations and other Asian economies, in particular, Malaysia, Taiwan, and China. Cambodia got only about 8 percent of its inward FDI in fixed assets over the period 1994-2004 from the USA, compared to Malaysia 37 %, Taiwan 12 %, and China 9 %. At the very the start of the liberalization of the economy, foreign investors relied most frequently on Cambodian-foreign joint ventures as their mode of entry. However, the popularity of this mode quickly vaporized and wholly foreign owned FDI became the foreign firms preferred entrance into the Cambodian economy.

The sectoral distribution of inward FDI in Cambodia, is dominated on the one hand by the labour-intensive garments and textiles industry with almost one third of the total, and on the other hand by the service sector which is largely based on Cambodia's rich cultural, touristic sites, i.e., the hotel and restaurant business with about one fifth and transportation (15.5%). FDI in manufacturing is strongly concentrated in the capital city Phnom Penh and in the surrounding Kandal province as they hosted 92% of Cambodia's approved inward FDI in terms of employment. Most of the hotels and restaurants are located in Siem Reap, because of the vicinity of the country's major tourist attractions. The government's efforts to encourage FDI activities in other industries, such as agriculture and infrastructure have not been successful. The extremely uneven geographical distribution of inward FDI coincides with the spread of the overall economic activity of the country and is related to the absence of skilled workers, and the lack of basic services such as infrastructure, security, communication and transportation in the rest of the country.

In a certain sense, the development of Cambodia's industries, in particular, the garments and textile sector, happened by "chance" (Porter, 1990). Inward FDI flows into those sectors occurred when the exports of garments by more advanced Asian countries, e.g. China were confronted with trade barriers (quotas) in the industrial countries. In a way this resulted in the 'discovery' of the competitive advantage of Cambodia's garment and textile industries, i.e., the large reserve of the low-cost, unskilled labour force, by the foreign companies that could no longer export directly to the markets of the EU or the USA. Because of its status as the a Less-Developed Country in the 'Everything but Arms Scheme' and the Generalized System of Preferences of the industrialized nations Cambodia became a platform exporter. The competitive advantages of the tourism sector are clearly based on Cambodia's cultural heritage for which the supporting industries of transportation and restaurant and hotel activities allow its expansion.

There are indications of technology transfers by the foreign firms in Cambodia mainly through the use of imported sophisticated machinery and on-the-job training programmes. The contribution of FDI to the Cambodia's capital stock has on average, been estimated to reach 21 percent of the capital formation in fixed assets during 1994-2004. Exports of the heavily invested garments and textiles industry increased steadily during the same period.

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[36] However, it should be mentioned, that such import substitution effect is only found when changes in the stock of FDI are considered.

FDI is generally believed to generate employment, in the host country at least if the crowding-out effects surpass the crowding-in effects. Between 1994 and 2004, inward FDI in Cambodia generated 390 thousand jobs. Assuming that during this period no disinvestments and job losses occurred in foreign owned firms, the employment in foreign subsidiaries represented 5 per cent of the Cambodian labour force. Two studies (Yamagata, 2006 and Hing and Tuot, 2007) confirmed the significant contribution of FDI activities to employment creation and consequently also to poverty reduction in Cambodia. The World Bank (2006) acknowledged that the poverty rate in Cambodia dropped by 10 to 15 percentage points during 1994-2004. Given the creation of employment, the contribution to the country's GDP, and to exports, FDI contributed significantly to the economy of this civil war-ravaged Kingdom though multiplier and spillover effects. More jobs and income might have been realized, however, if all approved FDI had materialized.

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