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Determinants of foreign direct investment in Cambodia<sup>☆</sup>Ludo Cuyvers<sup>a,b,\*</sup>, Reth Soeng<sup>c,1</sup>, Joseph Plasmans<sup>d,2</sup>, Daniel Van Den Bulcke<sup>e,3</sup><sup>a</sup> University of Antwerp, Kipdorp 61, 2000 Antwerp, Belgium<sup>b</sup> North-West University, Potchefstroom, South Africa<sup>c</sup> Research Centre for Foreign Policy and University of Antwerp, Lange Sint-Annastraat 7, 2000 Antwerp, Belgium<sup>d</sup> University of Antwerp, Prinsstraat 13, 2000 Antwerp, Belgium<sup>e</sup> University of Antwerp, IOB, Prinsstraat 13, 2000 Antwerp, Belgium

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## ABSTRACT

This paper analyses the determinants of the factors that might influence inward FDI in Cambodia by referring to its economic, geographic, and political characteristics. Using exclusive unbalanced panel data sets during 1995–2005, for both approved and realized FDI for, respectively, seventeen and fifteen home countries, the estimation results show that the determinants of approved FDI and realized FDI are somewhat similar. The FDI home country's GDP, its bilateral trade with the host country and the exchange rate have a positive impact on inward FDI flows into Cambodia. As expected, geographic distance negatively affects the level of FDI inflows in Cambodia.

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## 1. Introduction

Cambodia became a destination of foreign direct investment (FDI) after the country's first general elections which were held in 1993. Although Cambodia attracted certain amounts of foreign investment before the UN-backed general election in 1993 (see further) no reliable firm level longitudinal data on inward FDI could be found.<sup>4</sup> Based on approved foreign-invested projects<sup>5</sup> FDI in Cambodia originated from 32 countries during the period 1994–2005.<sup>6</sup> According to this source the majority of Cambodia's inward FDI was of Asian origin, and came more particularly from Malaysia, Taiwan, and China, which together accounted for about 60 per cent of the total. FDI from developed countries was quite small both in absolute and relative terms. The FDI from the world's largest investors i.e., the United States (US) and the European Union (EU) in Cambodia during

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<sup>4</sup> As far as could be verified reliable official data on FDI were only made available from August 1994 onwards. Because the FDI do not cover the complete year, 1994 was not included in the period for which the econometric analysis was applied (see further).

<sup>5</sup> Approved investment (approved FDI) refers to projects that have been officially authorized by the Cambodian Investment Board (CIB) of the Council for the Development of Cambodia (CDC).

<sup>6</sup> The riel is Cambodia's currency.

1994–2004 only reached 8.4 per cent and 7 per cent of total FDI in Cambodia, respectively. FDI from Japan was even more limited, accounting for a negligible 0.4 per cent in Cambodia's total FDI (Cuyvers, Soeng, & Van Den Bulcke, 2009).

The sectoral distribution of FDI in the Cambodian economy shows a very uneven pattern. FDI is concentrated in labour-intensive, export-oriented manufacturing industries, such as garments and is important in tourism-related sectors such as hotels and restaurants. Although the Cambodian Government encourages FDI in agriculture and the agro-industry, the cumulative FDI in these two sectors accounted only for about 5 per cent of the total FDI in the country.

FDI in Cambodia is very unevenly spread across the country. The capital city of Phnom Penh and the surrounding Kandal province attracted by far the largest share with 82 per cent of total FDI. Sihanoukville came in second position and yet only represented 8 per cent between 1994 and 2004. Although the Government promoted Special Promotion Zones/Special Economic Zones in some parts of the country, most of these areas hosted virtually no FDI.

Three main contributions are expected from the study of Cambodia's determinants of inward FDI by looking at the economic and geographic as well political characteristics of the country. First, the fact that the limited information about FDI activities in Cambodia is relatively recent and only goes back to the middle of the 1990s makes it an interesting case, especially because the factors that have influenced the inflows are not well understood. Second, Cambodia evolved from a strictly regulated and centralized economy to a more dynamic and open business environment in general and for foreign investors in particular. Improvements such as the simplification of the investment law, the introduction of a competitive corporate tax, a liberal investment policy and a wider openness to the rest of the world made the country and its large labour pool more attractive to foreign enterprises. It is useful to evaluate the success of these policy changes. Third, it will be tried to shed some light on the role that inward FDI played in the further economic development of Cambodia, particularly by taking into account the scope for FDI from its more advanced ASEAN partner countries. For these reasons this paper intends to contribute to the literature on the determinants of FDI in host developing and transitional economies in general and in Cambodia in particular. The speed of regional economic integration during and after the successful implementation process of the ASEAN Free Trade Agreement, in which Cambodia took part when it became a member of ASEAN on 30 April 1999, and the intended creation of the ASEAN Economic Community in 2015, is likely to strengthen and further increase the FDI flows in the region and into Cambodia coming from more developed partner countries such as Singapore, Malaysia and Thailand. This study should allow a better understanding of how intra-regional investment liberalization by less-developed ASEAN countries has an effect on inward FDI and can contribute to ASEAN regional integration.

The remainder of this paper is organized as follows. Section 2 briefly describes the development of FDI in Cambodia. In Section 3 the relevant literature is reviewed and the hypotheses are outlined. Section 4 presents the econometric model, while the presentation of the data takes place in Section 5. The estimation methodology and estimation results are discussed in Sections 6 and 7. In Section 8 some conclusions are drawn.

## 2. Development of foreign direct investment in Cambodia

Inward FDI into Cambodia can be traced back to the late 1950s (Chap, 2006). During this period, the main countries of origin of these investments were France, China and Japan. These investments were concentrated in industries such as textiles, rubber, plastics, paper, cement, automobile tires, chemicals, metal, and other manufacturing. In 1955, there were 650 investment projects worth 36 million riels.<sup>7</sup> The number of projects increased noticeably and reached 3707 in 1967 with investment amounts rising to 2521 million riels. In the 1970s, investment came to a complete halt as a result of civil wars and the genocidal Pol Pot regime, which was overthrown in January 1979. During 1979–1989, all the remaining enterprises were state-owned, and practically no FDI went into Cambodia as the country suffered from political upheaval, economic embargo and international isolation (Chap, 2006).

Cambodia again succeeded in attracting foreign direct investment in the late 1980s when the country was transformed from a centrally controlled to a free market-oriented economy. In 1989, a foreign investment law was approved by the National Assembly. It was followed by a sub-decree, issued by the Council of Ministers in 1991, which detailed the interpretation and implementation of the investment law. During 1991–1993, the country attracted FDI worth US\$ 1200 million into 638 projects (Chap, 2006), concentrated in tourism, banking, construction, manufacturing and agriculture, which mainly came from five economies, namely Thailand, Malaysia, Singapore, Hong Kong, and France. At that time there was already a shift to Asian home countries.

After the UN-backed national election in 1993, which resulted in the creation of the new coalition government, the Council for the Development of Cambodia/Cambodian Investment Board became responsible for approving investment applications. A new law on investment was drafted and subsequently approved by the National Assembly in 1994. Compared to other countries in the region, this new investment law was regarded as quite liberal, offering generous incentive packages to investors, both domestic and foreign, on a non-discriminatory basis (Asian Development Bank, 2006). The 1994 investment law was revised in 2003. As part of the new investment regime, a sub-decree was issued to provide a legal framework to establish Special Economic Zones (SEZs) in late 2005 in order to promote economic and processing activities.

Based on the CIB's Cambodian Investment Statistics, 1994–2004, Cambodia attracted FDI of about US\$ 5313 million in fixed assets during 1994–2004. The main source economies of FDI were ASEAN and other Asian countries, particularly

<sup>7</sup> The ASEAN member countries investing in Cambodia include Malaysia, Indonesia, Singapore, the Philippines, Thailand, and Vietnam.

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