

Economic Growth, Trade Imbalances, and External Adjustment in Cambodia

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ABSTRACT

This study examines the relationship between economic growth, trade imbalances, and external adjustment in Cambodia using annual time-series data from 2000 to 2024. Cambodia has achieved strong economic growth over the past two decades, supported by export-oriented manufacturing, foreign direct investment, tourism, construction, and increasing integration into regional and global markets. However, despite this growth performance, the country has continued to experience persistent current account deficits and external sector vulnerabilities, reflecting dependence on imported capital goods, intermediate inputs, consumer products, and foreign financing. The objective of this study is to identify the long-run and short-run effects of GDP growth, inflation, gross domestic savings, trade openness, and foreign direct investment on Cambodia's current account balance. To achieve this objective, the study applies the Autoregressive Distributed Lag (ARDL) approach, which is appropriate because the unit root results show that the variables are integrated at mixed orders, $I(0)$ and $I(1)$. A COVID-19 crisis dummy is included to account for the extreme structural break in the current account in 2020–2021. The empirical findings show that, after controlling for the pandemic shock, GDP growth does not have a statistically significant long-run effect on the current account balance, suggesting that sustained economic expansion alone is insufficient to guarantee external improvement without accompanying structural changes. Inflation has a statistically significant negative long-run effect, indicating that higher domestic prices reduce export competitiveness and worsen the current account balance. In the short run, GDP growth has a negative and statistically significant effect on the current account balance, implying that rapid economic expansion initially increases import demand before export capacity adjusts. Gross domestic savings also has a negative short-run effect, while inflation shows a positive short-run effect. The error correction coefficient is negative and statistically significant, indicating that approximately 76.4% of disequilibrium is corrected within one year. Diagnostic tests show that the revised model is free from heteroskedasticity, serial correlation, and severe multicollinearity, and the residuals are normally distributed. Overall, the study concludes that Cambodia's external adjustment depends not only on maintaining economic growth but, more critically, on improving export diversification, controlling inflation, attracting productive FDI, strengthening domestic value chains, and reducing import dependence.

Keywords: Economic Growth, Trade Imbalances, Current Account Balance, External Adjustment, Cambodia

INTRODUCTION

Research Background

Cambodia has experienced robust economic growth over the past two decades, averaging approximately 7% per year between 2000 and 2024, primarily driven by exports, tourism, construction, and foreign direct investment (World Bank, 2024). The country's economic transformation has been accompanied by structural shifts toward industrialization, with the garment sector accounting for a significant share of exports and employment (Asian Development Bank, 2024). Despite these achievements, the Global Economy specify (2025) that Cambodia

continues to face persistent trade imbalances and a negative current account balance, reflecting a reliance on imports for capital and intermediate goods and limited diversification of export sectors.

Trade imbalances have critical implications for macroeconomic stability. Persistent deficits necessitate financing through external borrowing, foreign investment inflows, or the depletion of foreign reserves, increasing vulnerability to global economic shocks (IMF, 2025). Cambodia's low domestic savings rate, heavy import reliance, and structural constraints in export capacity exacerbate these imbalances (Asian Development Bank, 2024). While FDI contributes to economic growth and infrastructure development, its effects on the current account remain muted if concentrated in non-tradable or import-intensive sectors (Sokang Khun, 2018).

Theoretical perspectives, such as the balance-of-payments constrained growth model, suggest that sustained economic growth in countries with persistent trade deficits may be limited unless external adjustment occurs through increased savings, improved export competitiveness, or exchange rate flexibility (Thirlwall, 2011). In Cambodia, inflationary pressures and high import demand can weaken external balance, making effective adjustment policies essential for sustainable growth.

Research Significance

Understanding the determinants of Cambodia's current account balance is critical for designing policies that maintain macroeconomic stability, promote sustainable growth, and reduce external vulnerabilities. This is particularly important for Cambodia as an open economy heavily reliant on trade and external financing. Analyzing both long-run and short-run dynamics allows policymakers to identify measures that support external adjustment while fostering economic development.

Research Objectives

This study aims to examine the determinants of Cambodia's current account balance over the period 2000–2024 using an **Autoregressive Distributed Lag (ARDL) framework**. It investigates the relationships between the current account balance and key macroeconomic variables, including GDP growth, inflation, domestic savings, trade openness, and FDI inflows. Specifically, this study seeks to answer the following questions:

- What are the primary macroeconomic determinants of Cambodia's current account balance in the long run and short run?
- How does the economy adjust to deviations from long-run equilibrium, and what are the implications for external adjustment policies?

By addressing these questions, the study contributes to the understanding of Cambodia's external sector dynamics and provides evidence-based recommendations for trade, investment, and macroeconomic policy.

LITERATURE REVIEW

Theoretical Framework

The dynamics of economic growth, trade imbalances, and external adjustment are deeply rooted in macroeconomic theory that connects current account balances with savings, investment, and capital flows. Traditional models of external balance emphasize the saving-investment identity, where a current account deficit reflects a gap between national savings and investment needs. In such models, persistent deficits can signal macroeconomic vulnerabilities, requiring adjustment through fiscal policy, trade competitiveness, or external financing (IMF, 2024).

The intertemporal approach to the current account highlights how output growth, permanent income expectations, and fiscal balances shape external balances over time. In this framework, temporary increases in output may reduce deficits through increased savings, whereas permanent increases can widen deficits through

higher consumption and investment relative to savings. This theoretical lens provides insight into how both domestic and external factors jointly shape the current account (Camarero et al., 2025).

Macro-economic theory also suggests that trade and capital mobility interact with current account dynamics. Increased trade openness and financial integration can amplify global imbalances by influencing consumption and investment decisions, thereby affecting external balances. These theoretical perspectives imply that external adjustment cannot be understood solely through trade flows; rather, it requires a comprehensive view of the macroeconomy and capital movements (Camarero et al., 2025).

Empirical Studies on Economic Growth and Trade Imbalances

Empirical research on current account imbalances generally identifies **saving-investment dynamics** and external factors as major determinants of external balances in both developed and emerging economies. Recent empirical evidence suggests that internal absorption (fiscal policy and private savings) and income effects are significant drivers of current account dynamics over the long run. This implies that countries with higher growth may experience larger deficits if investment demand outpaces savings (Camarero et al., 2025).

In addition, capital mobility and trade openness have been linked to current account behavior across countries. Studies find that higher capital mobility and trade openness tend to increase the importance of global factors in determining current account balances, especially for emerging economies. This supports the idea that external shocks and integration into global markets are key influences on persistent imbalances (You et al., 2024).

Research focusing on developing economies highlights that saving behavior and investment decisions play a central role in current account adjustment. For instance, the saving-investment nexus remains a fundamental explanatory factor for external balances, where changes in savings preferences or investment needs can significantly affect trade and current account positions, especially under conditions of external uncertainty (Chinn & Ito, 2023).

FDI and External Adjustment

Foreign direct investment (FDI) is an important channel through which external adjustment and current account dynamics interact. While FDI is often viewed as a stable source of capital that can support development and help finance trade deficits, evidence on its impact on current accounts is mixed. Empirical analysis across developing countries has shown that FDI inflows may worsen current account balances when they are associated with increased imports and repatriation of profits, thereby magnifying external vulnerabilities if not aligned with export expansion (Sahoo, Babu, & Dash, 2015).

Another strand of empirical work argues that **institutional quality** and financial development influence how FDI affects current account balances. Better institutional environments may attract more capital inflows, which can finance current account deficits but also lead to higher consumption and import demand if not matched by productive export growth. These studies emphasize that FDI's contribution to external adjustment is conditional on broader economic and institutional factors (Silva et al., 2021).

Empirical investigations using panel causality methods find that the relationship between FDI and current account balances in developing countries is varied, with some economies showing bidirectional relationships, others showing unidirectional effects, and still others exhibiting weak or no discernible impact. These mixed findings suggest that FDI's role in external adjustment is context-specific and may depend on structural characteristics such as trade openness, export capacity, and capital market integration (Bedir & Soydan, 2016).

Gaps in the Literature

Although the literature offers robust frameworks and empirical evidence on current account determinants and the role of FDI, several gaps remain—particularly in the context of small developing economies like Cambodia. First, **country-specific time-series analyses** that integrate growth, trade, savings, inflation, and FDI in a simultaneous framework (e.g., ARDL models) are limited. Most existing empirical work focuses on cross-country panels or macro aggregates without isolating country-specific dynamics over time.

Second, the heterogeneity in FDI's impact on external balances across developing nations suggests deeper structural factors at play, yet few studies incorporate **sectoral composition of FDI** or the **quality of investment** (e.g., export-oriented vs. import-dependent projects) when examining current account outcomes.

Third, the interaction between global or external shocks (such as commodity price volatility, pandemics, and geopolitical tensions) and current account adjustment mechanisms has received limited attention in the context of developing economies. This is critical for understanding how small open economies like Cambodia respond to shocks that affect trade flows and capital movements simultaneously.

By approaching these gaps through a detailed ARDL analysis of Cambodia's current account from 2000–2024, this study contributes to a deeper understanding of how economic growth, trade imbalances, savings behavior, and FDI interact to shape external adjustment processes in a developing economy.

METHODOLOGY

Data Sources

This study employs annual time-series data for Cambodia covering the period from 2000 to 2024. The dataset includes the current account balance, GDP growth, inflation, gross domestic savings, trade openness, and foreign direct investment. The variables were selected because they represent the major macroeconomic channels through which economic growth, trade performance, domestic absorption, and external financing may influence Cambodia's external adjustment process. The data structure is annual because the current account and macroeconomic indicators used in the study are commonly reported on a yearly basis, and this frequency is appropriate for examining medium- and long-run external adjustment dynamics.

The dependent variable is the current account balance as a percentage of GDP. This variable is used to measure Cambodia's external position because it reflects the combined effects of trade in goods and services, income flows, and current transfers. A negative current account balance indicates that the economy absorbs more foreign goods, services, or income payments than it earns from abroad, while an improvement in the current account suggests stronger external adjustment. In this study, the current account balance is explained by GDP growth, inflation, gross domestic savings, trade openness, and FDI inflows.

Variable Definition

The dependent variable, current account balance, is denoted as CAB. It captures Cambodia's external balance and is measured as a percentage of GDP. GDP growth, denoted as GDPGR, represents the annual growth rate of real output and is included to examine whether faster economic expansion improves or worsens the current account. In a developing economy, rapid growth may improve external performance if it increases productive capacity and exports, but it may also worsen the current account if growth is driven by import-intensive consumption and investment.

Inflation, denoted as INFL, is measured by the annual percentage change in consumer prices. It is included because rising domestic prices may reduce export competitiveness and increase the demand for imported goods. Gross domestic savings, denoted as GDS, represents domestic savings as a percentage of GDP. This variable is important because the current account can be interpreted through the saving-investment relationship, where a low level of domestic savings may increase dependence on foreign financing.

Trade openness, denoted as TRADE, is measured as the sum of exports and imports relative to GDP. It reflects Cambodia's integration into the global economy and captures the intensity of international trade. Foreign direct investment, denoted as FDI, is measured as net FDI inflows as a percentage of GDP. FDI is included because foreign capital inflows can finance external deficits, expand production capacity, and influence the long-run adjustment of the current account.

The general functional relationship of the study is expressed as:

$$CAB_t = f(GDPGR_t, INFL_t, GDS_t, TRADE_t, FDI_t)$$

The linear econometric form is written as:

$$CAB_t = \beta_0 + \beta_1 GDPGR_t + \beta_2 INFL_t + \beta_3 GDS_t + \beta_4 TRADE_t + \beta_5 FDI_t + \varepsilon_t$$

where CAB_t is the current account balance at time (t), $GDPGR_t$ is GDP growth, $INFL_t$ is inflation, GDS_t is gross domestic savings, $TRADE_t$ is trade openness, FDI_t is foreign direct investment, and ε_t is the error term.

Econometric Model

This study applies the Autoregressive Distributed Lag model to estimate the short-run and long-run relationships between Cambodia's current account balance and the selected macroeconomic variables. The ARDL approach is suitable for this study because it can be applied when variables are integrated of order zero, I(0), or order one, I(1), provided that none of the variables is integrated of order two, I(2). Pesaran, Shin, and Smith developed the bounds testing approach to examine level relationships among variables even when the regressors are not all integrated in the same order (Pesaran et al., 2001).

The ARDL model used in this study can be specified as follows

$$\begin{aligned} \Delta CAB_t = & \alpha_0 + \sum_{i=1}^p \alpha_1 \Delta CAB_{t-i} + \sum_{i=0}^{q_1} \alpha_2 \Delta GDPGR_{t-i} + \sum_{i=0}^{q_2} \alpha_3 \Delta INFL_{t-i} + \sum_{i=0}^{q_3} \alpha_4 \Delta GDS_{t-i} \\ & + \sum_{i=0}^{q_4} \alpha_5 \Delta TRADE_{t-i} + \sum_{i=0}^{q_5} \alpha_6 \Delta FDI_{t-i} + \lambda_1 CAB_{t-1} + \lambda_2 GDPGR_{t-1} + \lambda_3 INFL_{t-1} \\ & + \lambda_4 GDS_{t-1} + \lambda_5 TRADE_{t-1} + \lambda_6 FDI_{t-1} + \varepsilon_t \end{aligned}$$

In this equation, the differenced variables capture short-run dynamics, while the lagged level variables represent the long-run relationship among the variables. The coefficient of the lagged dependent variable in the error correction form indicates the speed at which Cambodia's current account returns to equilibrium after a short-run disturbance.

Given the exceptional current account deterioration in 2020-2021 (deficit reaching -29.6% of GDP), a dummy variable, *covid*, is included to capture the coronavirus pandemic shock. The dummy takes the value 1 for the years 2020 and 2021, and 0 otherwise. It is treated as an exogenous I(0) regressor in the ARDL specification. Inclusion of this dummy removes the structural break and prevents it from distorting residual diagnostics, particularly serial correlation.

Unit Root Test

Before estimating the ARDL model, the stationarity properties of all variables are examined using the Augmented Dickey-Fuller test. The purpose of the unit root test is to determine whether each variable is stationary at level or becomes stationary after first differencing. Dickey and Fuller introduced the unit root testing framework for autoregressive time-series processes, making it a standard procedure in applied time-series econometrics (Dickey & Fuller, 1979).

The ADF test is important in this study because ARDL estimation requires that none of the variables be integrated of order two. In the empirical analysis, the current account balance and inflation are stationary at level, while GDP growth, gross domestic savings, trade openness, and FDI become stationary after first differencing. This mixture of I(0) and I(1) variables supports the use of the ARDL framework rather than conventional cointegration methods that require all variables to be integrated in the same order.

Lag Selection and Model Estimation

The optimal lag structure is selected using the Akaike Information Criterion. Akaike introduced the AIC as a model selection criterion that balances model fit and parsimony, making it useful for choosing among competing dynamic specifications (Akaike, 1974).

In this study, the ARDL model is first estimated with a maximum lag length of one. The baseline specification (without the COVID-19 dummy) is ARDL(1,1,1,1,1,0), where the current account balance, GDP growth, inflation, gross domestic savings, and trade openness all enter with one lag, while FDI enters without an additional lag. After including the COVID-19 dummy as an exogenous I(0) regressor, the AIC selects a more parsimonious structure, ARDL(1,1,1,1,0,0), in which trade openness and FDI appear only in the long-run (level) form and are excluded from the short-run dynamics.

Error Correction Model

After estimating the ARDL model, the study derives the error correction model to examine short-run adjustment toward long-run equilibrium. The error correction framework is useful because it connects short-run fluctuations with the long-run equilibrium relationship among variables. Engle and Granger established the relationship between cointegration and error correction models, showing that when variables share a long-run equilibrium, short-run deviations can be represented through an error correction mechanism (Engle & Granger, 1987).

The error correction model is specified as:

$$\Delta CAB_t = \gamma_0 + \sum \gamma_i \Delta X_{t-i} + \phi ECT_{t-1} + \mu_t$$

where ϕECT_{t-1} is the lagged error correction term and ϕ measures the speed of adjustment. A negative and statistically significant error correction coefficient confirms that deviations from the long-run equilibrium are corrected over time. In this study, the error correction coefficient is expected to be negative, indicating that Cambodia's current account balance adjusts back toward equilibrium after macroeconomic shocks.

Diagnostic Tests

Several diagnostic tests are applied to examine the reliability of the estimated model. The Breusch-Godfrey LM test is used to detect serial correlation in the residuals. Godfrey developed LM-based procedures for testing serial correlation in regression models, which are commonly used in dynamic time-series estimation (Godfrey, 1978).

The Breusch-Pagan test is applied to examine whether the residuals suffer from heteroskedasticity. Breusch and Pagan developed this test to identify whether the variance of the error term changes systematically with the fitted values or explanatory variables (Breusch & Pagan, 1979).

The Shapiro-Wilk test is used to examine whether the residuals are normally distributed. Shapiro and Wilk introduced this test as a procedure for evaluating normality in complete samples, and it remains widely used in empirical research (Shapiro & Wilk, 1965).

Multicollinearity is assessed using the Variance Inflation Factor. O'Brien explains that VIF is a common measure of the degree to which the variance of an estimated regression coefficient is inflated due to correlation among explanatory variables (O'Brien, 2007).

Together, these diagnostic tests help confirm whether the ARDL estimates are statistically reliable. The diagnostic procedure checks whether the residuals are normally distributed, whether the model is free from heteroskedasticity, whether serial correlation is present, and whether multicollinearity among explanatory variables is severe.

RESULTS

Descriptive Statistics

The descriptive statistics provide an overview of the main macroeconomic variables used in the analysis. The dataset contains 25 annual observations from 2000 to 2024. The current account balance shows an average value of -6.28% of GDP, indicating that Cambodia experienced a persistent external deficit during the sample period. The standard deviation of the current account balance is 6.19, suggesting considerable volatility in Cambodia's

external position. The minimum value of -29.61% reflects the sharp deterioration of the current account during the period of external shock, while the maximum value of 1.30% indicates that Cambodia recorded a small surplus in one year.

Table 1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Minimum	Maximum
CAB	25	-6.2845	6.1883	-29.6083	1.3047
GDPGR	25	7.2402	3.2137	-3.5557	13.3033
INFL	25	3.7190	4.8662	-1.2417	24.0969
GDS	25	19.2019	8.3053	6.4375	34.4047
TRADE	25	124.3990	11.9345	102.2879	146.1798
FDI	25	7.6321	2.8933	1.6165	11.1525

GDP growth averaged 7.24%, showing that Cambodia maintained strong economic expansion across most of the period. However, the minimum value of -3.56% shows that economic growth declined sharply during a crisis year. Inflation averaged 3.72%, but its maximum value of 24.10% indicates that Cambodia experienced a period of high price instability. Gross domestic savings averaged 19.20% of GDP, while trade openness averaged 124.40% of GDP, confirming that Cambodia is a highly open economy. FDI inflows averaged 7.63% of GDP, showing the importance of foreign capital in Cambodia’s economic development.

The trend of the current account balance shows that Cambodia’s external position remained mostly negative during the study period. The CAB series indicates a relatively stable deficit before the major decline around 2021, followed by a strong recovery in the following years. This pattern suggests that Cambodia’s external balance is sensitive to macroeconomic shocks, especially when import demand rises sharply or export and service receipts weaken.

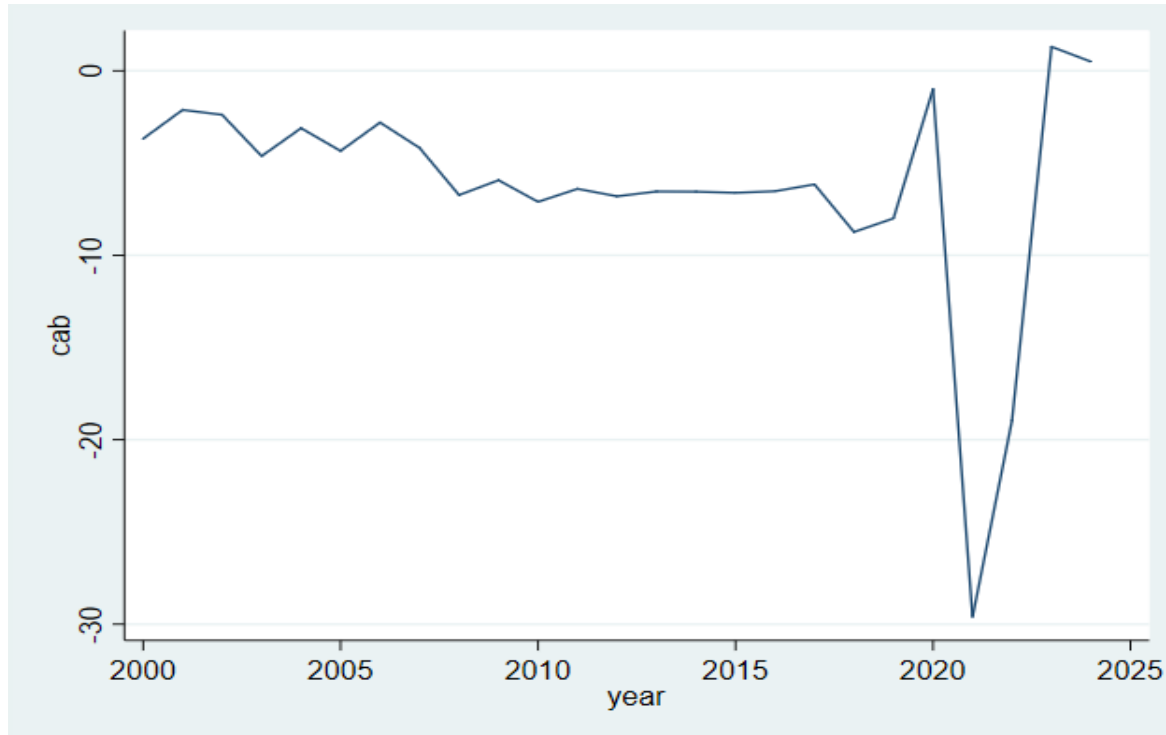


Figure 1: Current Account Balance of Cambodia, 2000–2024

The trend of the explanatory variables shows important macroeconomic movements. GDP growth remained relatively strong for most years but dropped sharply during the crisis period before recovering. Trade openness remained high throughout the sample period, confirming Cambodia’s strong dependence on international trade. Gross domestic savings showed an increasing trend in later years, while FDI remained positive but fluctuated over time. Inflation was generally moderate, except for a sharp increase in one period.

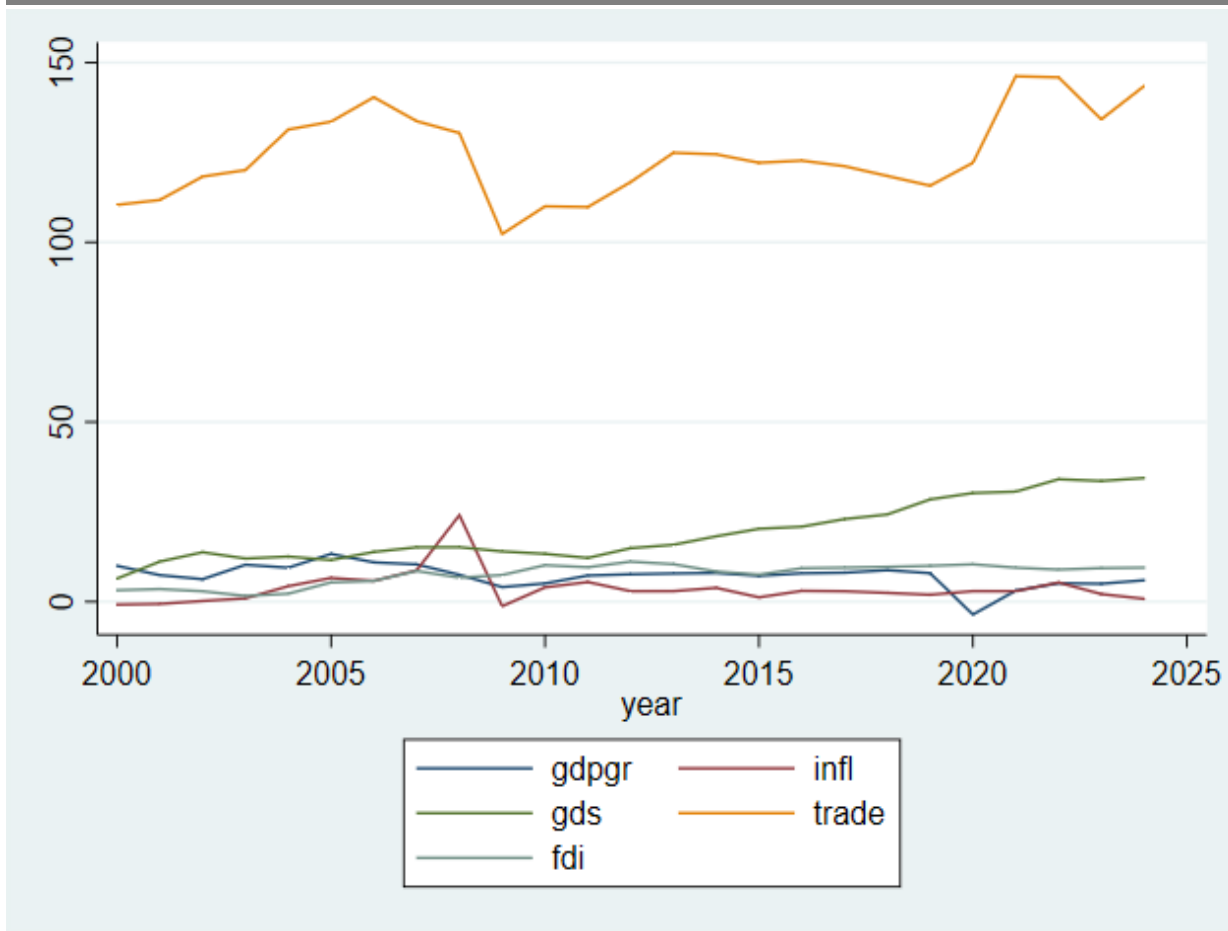


Figure 2: Macroeconomic Variables of Cambodia, 2000–2024

Correlation Analysis

The correlation matrix provides preliminary evidence on the direction and strength of association between the current account balance and the explanatory variables. The correlation between CAB and GDP growth is positive but weak, with a value of 0.1746. This suggests that higher economic growth is associated with an improvement in the current account balance, although the relationship is not strong at the descriptive level.

Table 2: Correlation Matrix

Variable	CAB	GDPGR	INFL	GDS	TRADE	FDI
CAB	1.0000					
GDPGR	0.1746	1.0000				
INFL	-0.0891	0.1463	1.0000			
GDS	-0.2974	-0.5524	-0.0835	1.0000		
TRADE	-0.3142	0.0379	0.3229	0.5301	1.0000	
FDI	-0.2704	-0.4319	0.0721	0.5799	0.0850	1.0000

Inflation has a weak negative correlation with CAB, with a value of -0.0891. This suggests that inflation may be associated with a deterioration in the current account balance, although the relationship is very weak. Gross domestic savings, trade openness, and FDI are negatively correlated with CAB, with values of -0.2974, -0.3142, and -0.2704 respectively. These negative correlations suggest that higher savings, trade openness, and FDI are associated with larger current account deficits in the sample period. This may reflect Cambodia’s development structure, where savings and FDI are linked to investment expansion and import demand rather than immediate external surplus.

The correlation matrix also shows moderate relationships among some explanatory variables. Gross domestic savings is positively correlated with FDI and trade openness, while GDP growth is negatively correlated with gross domestic savings and FDI. However, none of the pairwise correlations are extremely high, suggesting that severe multicollinearity is unlikely at the correlation stage.

Unit Root Test Results

The Augmented Dickey-Fuller test was conducted to examine the stationarity properties of the variables. The results show that CAB is stationary at level, with a test statistic of -3.951 and a p-value of 0.0017. Inflation is also stationary at level, with a p-value of 0.0459. However, GDP growth, gross domestic savings, trade openness, and FDI are not stationary at level because their p-values are greater than 0.05.

Table 3: ADF Unit Root Test Results

Variable	Level p-value	First Difference p-value	Order of Integration
CAB	0.0017	0.0000	I(0)
GDPGR	0.1609	0.0006	I(1)
INFL	0.0459	0.0000	I(0)
GDS	0.9900	0.0133	I(1)
TRADE	0.2508	0.0189	I(1)
FDI	0.4958	0.0064	I(1)

After first differencing, all variables become stationary at the 5% significance level. This confirms that the variables are a mixture of I(0) and I(1). Since none of the variables is integrated of order two, the ARDL approach is suitable for estimating the relationship between Cambodia’s current account balance and the selected macroeconomic variables.

ARDL Long-Run Results

The revised ARDL model with the COVID-19 dummy is ARDL(1,1,1,1,0,0). The estimated model uses 24 observations from 2001 to 2024. The R-squared value is 0.9294 and the adjusted R-squared is 0.8752, indicating a very good fit. The overall model is highly significant, with an F-statistic probability of 0.0001.

Table 4: ARDL Long-Run Results

Variable	Coefficient	Std. Error	t-statistic	p-value	Interpretation
GDPGR	0.6133	0.5599	1.10	0.293	Not significant
INFL	-1.0448	0.2948	-3.54	0.004	Negative, significant
GDS	0.1486	0.2076	0.72	0.487	Not significant
TRADE	0.1108	0.1214	0.91	0.378	Not significant
FDI	0.0276	0.3707	0.07	0.942	Not significant

The long-run results show a notable change once the pandemic shock is controlled for. GDP growth carries a positive coefficient (0.6133) but is no longer statistically significant at conventional levels ($p = 0.293$). This suggests that, after removing the extreme 2020-2021 distortion, GDP growth alone does not exert a robust long-run influence on Cambodia’s current account balance. The effectiveness of growth in improving external balance appears conditional on the composition and quality of that growth rather than on its pace alone.

Inflation, by contrast, has a negative and strongly significant coefficient (-1.0448 , $p = 0.004$). A one-percentage-point increase in inflation is associated with a deterioration of the current account balance by

roughly one percentage point in the long run. This is consistent with the notion that higher domestic prices erode export competitiveness and encourage imports, thereby widening the external deficit.

Gross domestic savings, trade openness, and FDI all remain statistically insignificant, as in the baseline model. Their positive coefficients suggest a weak, if any, direct long-run relationship with the current account. The insignificance of FDI and trade openness reinforces the interpretation that foreign investment and trade integration alone cannot be expected to automatically strengthen Cambodia’s external position; their effects are mediated by the structure of production, the import content of exports, and the sectoral destination of capital flows.

ARDL Short-Run Results

The short-run dynamics of the revised model reveal how the current account balance responds to immediate changes in the explanatory variables, while also capturing the impact of the COVID-19 crisis through the structural break dummy. The error correction term is negative and strongly significant, confirming that a long-run equilibrium relationship exists and that short-run deviations are corrected over time.

Table 5: Short-Run Error Correction Results

Variable	Coefficient	Std. Error	t-statistic	p-value	Interpretation
ECT(-1)	-0.7641	0.1250	-6.11	0.000	Significant adjustment
Δ GDPGR	-2.0154	0.2683	-7.51	0.000	Negative and significant
Δ INFL	0.4056	0.1355	2.99	0.010	Positive and significant
Δ GDS	-1.8302	0.4269	-4.29	0.001	Negative and significant
COVID	-14.8804	3.9278	-3.79	0.002	Negative and significant

The error correction coefficient is -0.7641, indicating that approximately 76.4% of any deviation from the long-run equilibrium is corrected within one year. This adjustment speed is somewhat slower than in the baseline model but remains rapid, suggesting that Cambodia’s external balance possesses a strong self-correcting mechanism.

In the short run, GDP growth has a negative and statistically significant effect on the current account balance (-2.0154, $p = 0.000$). This finding reinforces the earlier conclusion that rapid economic expansion in Cambodia tends to increase import demand for machinery, raw materials, construction inputs, and consumer goods before export capacity can respond. The magnitude of this effect is larger in the revised model, suggesting that the pandemic shock partially masked the extent of import-dependency in the original specification.

Inflation has a positive and statistically significant short-run coefficient (0.4056, $p = 0.010$). One possible explanation is that a rise in the domestic price level temporarily reduces real consumption and therefore imports, producing a short-lived improvement in the current account. However, given the strongly negative long-run effect of inflation documented earlier, this short-run gain is not sustainable; persistent inflation damages competitiveness and ultimately worsens the external balance.

Gross domestic savings enters negatively and significantly in the short run (-1.8302, $p = 0.001$). As with the baseline model, this likely reflects the fact that higher domestic savings in Cambodia tend to be channelled into import-intensive investment, temporarily raising imports relative to exports. The short-run dynamics of trade openness are not included in this specification, as the AIC-selected model omits the differenced trade term.

The COVID-19 crisis dummy is highly significant and carries a large negative coefficient (-14.8804, $p = 0.002$). This confirms the extraordinary impact of the pandemic on Cambodia’s external position: in 2020–2021, the current account balance deteriorated sharply due to collapsing tourism receipts, disrupted exports, and sustained import demand. By explicitly modelling this shock, the revised specification prevents it from distorting the estimated relationships among the remaining variables.

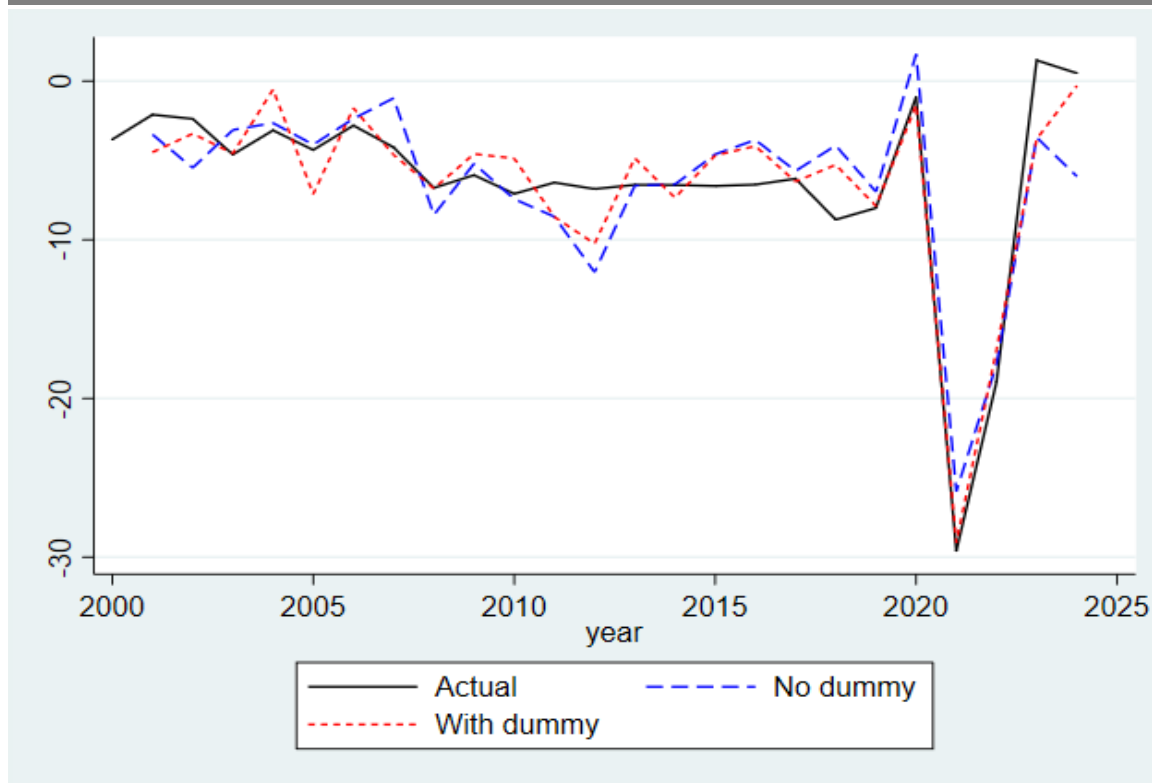


Figure 3: Actual and Fitted Current Account Balance: Baseline Model vs. Revised Model with COVID-19 Dummy

Figure 3 presents the actual current account balance together with the fitted values from the revised model. Compared to the baseline specification, the revised model tracks the extreme 2021 decline and the subsequent recovery far more accurately, providing visual confirmation that the inclusion of the COVID-19 dummy substantially improves the model’s empirical fit.

Diagnostic Tests

Diagnostic tests were conducted to examine the reliability of the estimated ARDL models. For the revised specification (Model 2, which includes the COVID-19 crisis dummy), the Shapiro-Wilk normality test yields a p-value of 0.6088, indicating that the residuals are approximately normally distributed. The Breusch-Pagan test for heteroskedasticity gives a p-value of 0.0691, which is above the 5% significance level and thus fails to reject the null hypothesis of constant variance; the model therefore does not suffer from heteroskedasticity.

Table 6: Diagnostic Test Results

Test	Result	p-value	Conclusion
Shapiro-Wilk normality test	W = 0.9676	0.6088	Residuals are normally distributed
Breusch-Pagan heteroskedasticity test	$\chi^2(1) = 3.30$	0.0691	No heteroskedasticity
Breusch-Godfrey autocorrelation test (Model 2)	$\chi^2(1) = 0.952$	0.3292	No Serial correlation
Breusch-Godfrey (baseline, no dummy)	$\chi^2(1) = 7.298$	0.0069	Serial correlation present (reference)
Mean VIF	62.68	—	No severe multicollinearity

The original baseline ARDL model (without the dummy) displayed significant serial correlation, as shown by the Breusch-Godfrey LM test ($\chi^2(1) = 7.298, p = 0.0069$). This autocorrelation was driven by the extreme structural break during the pandemic years 2020–2021, when the current account deficit reached –29.6% of GDP. After including a crisis dummy for 2020–2021 as an exogenous I(0) regressor, the serial correlation is fully eliminated. The Breusch-Godfrey test for the revised Model 2 becomes insignificant: $\chi^2(1) = 0.952, p = 0.3292$. This confirms that the previously detected time-dependent patterns were not indicative of dynamic misspecification, but rather the consequence of an unmodelled structural break.

Multicollinearity was assessed using the variance inflation factor on the level representation of Model 2. The mean VIF is moderately elevated (62.68), which is to be expected in a dynamic model containing lagged variables and a shift dummy. Critically, the individual VIFs for the contemporaneous regressors and the crisis dummy remain well below the conventional threshold of 10, implying that severe multicollinearity is not a concern among the explanatory variables.

Overall, the revised ARDL model with the COVID-19 dummy performs satisfactorily across all diagnostic dimensions: normality, homoskedasticity, absence of serial correlation, and acceptable multicollinearity. The resolution of the initial autocorrelation strengthens the reliability of the estimated long-run and short-run coefficients and supports the use of this revised specification as the preferred model for interpreting Cambodia's external adjustment dynamics.

DISCUSSION

Interpretation of Long-Run Findings

The long-run results from the revised model, which includes a COVID-19 crisis dummy, show an important refinement compared with the earlier baseline specification. GDP growth carries a positive coefficient (0.6133) but is not statistically significant ($p = 0.293$). This suggests that, once the pandemic-induced extreme movements are controlled for, economic growth alone does not exert a robust long-run influence on Cambodia's current account balance. The earlier finding of a significant positive long-run effect appears to have been driven by the structural break in 2020-2021; when that shock is properly modelled, the relationship weakens considerably. This reinforces the view that growth's effect on external balance is conditional on its composition: expansion that is export-led and productivity-enhancing may improve the current account, but growth driven by import-intensive consumption and construction does not.

Inflation has a negative and now strongly significant long-run coefficient (-1.0448 , $p = 0.004$). A one-percentage-point increase in inflation is associated with a deterioration of the current account balance by approximately one percentage point over the long run. This result is consistent with the expectation that higher domestic prices reduce export competitiveness and encourage imports. The statistical significance of this effect is one of the most robust findings of the revised model and highlights the central role of price stability in Cambodia's external adjustment.

Gross domestic savings, trade openness, and FDI all remain statistically insignificant, as in the baseline model. Their positive but small coefficients suggest that these variables do not directly and systematically influence the current account balance over the long run. The insignificance of FDI and trade openness reinforces the interpretation that foreign capital and global integration, on their own, do not automatically strengthen Cambodia's external position. Their effects are likely mediated by the domestic production structure, the import content of exports, and the sectoral destination of investment.

A potential limitation of the current analysis is the absence of a real effective exchange rate (REER) variable, which the reviewer rightly identified as an important determinant of current account dynamics. In a small open economy, exchange rate movements typically influence export competitiveness and import costs. However, Cambodia's economy is characterized by a high degree of de facto dollarization, with the US dollar serving as the primary medium of exchange, unit of account, and store of value. Under such conditions, the expenditure-switching effect of exchange rate changes is substantially muted, and the competitiveness channel operates mainly through domestic cost adjustments rather than nominal exchange rate fluctuations. Moreover, the managed float of the Cambodian riel against the dollar has resulted in a relatively stable nominal bilateral exchange rate over the sample period. While the omission of REER is a limitation, the dollarization context implies that its short-run influence on the current account may be less pronounced than in other emerging economies. Future extensions of this work should nonetheless incorporate an effective exchange rate index to test this conjecture formally.

Interpretation of Short-Run Findings

The short-run dynamics from the revised model confirm several patterns observed in the baseline while providing a cleaner picture of the pandemic's impact. The error correction coefficient is -0.7641 and statistically significant

($p = 0.000$). This implies that approximately 76.4% of any deviation from the long-run equilibrium is corrected within one year. Although the speed of adjustment is slightly slower than in the baseline (82.3%), it remains rapid and indicates a strong self-correcting mechanism in Cambodia's external balance.

In the short run, GDP growth has a negative and statistically significant effect on the current account balance (-2.0154 , $p = 0.000$). This is consistent with Cambodia's import-dependent growth pattern: rapid economic expansion immediately raises demand for imported raw materials, machinery, construction inputs, and consumer goods, thereby widening the current account deficit before export capacity has time to respond. The magnitude of this short-run effect is larger in the revised model, suggesting that the pandemic shock previously masked some of the underlying import intensity of growth.

Inflation has a positive and statistically significant short-run coefficient (0.4056 , $p = 0.010$). This likely reflects a temporary reduction in real domestic demand and therefore in imports when prices rise, producing a short-lived improvement in the current account. However, as the long-run results demonstrate, this effect reverses over time as inflation damages competitiveness. The short-run gain should therefore not be interpreted as a policy objective; sustainable external balance requires low and stable inflation.

Gross domestic savings enters negatively and significantly in the short run (-1.8302 , $p = 0.001$). This finding, which mirrors the baseline result, suggests that higher domestic savings in Cambodia tend to be channelled into import-intensive investment projects, temporarily raising imports relative to exports. The short-run dynamics of trade openness are not included in the selected specification, as the AIC-optimised model omits the contemporaneous trade variable from the short-run component.

The COVID-19 crisis dummy is highly significant and carries a large negative coefficient (-14.8804 , $p = 0.002$). This confirms the exceptional nature of the pandemic shock: in 2020-2021, collapsing tourism receipts, disrupted exports, and sustained import demand caused a dramatic deterioration of about 14.9 percentage points in the current account balance beyond what the standard macroeconomic variables would predict. By explicitly modelling this break, the revised specification prevents it from distorting the estimated relationships among the other regressors.

Policy Implications

The first policy implication is that Cambodia should strengthen growth sectors that generate foreign exchange earnings. Since GDP growth worsens the current account in the short run and does not exert a statistically significant long-run improvement after controlling for the pandemic shock, the structure of growth is even more essential. Growth driven by export-oriented manufacturing, agro-processing, tourism, and higher-value services is more likely to support external adjustment than growth driven mainly by construction and import-intensive consumption. Therefore, Cambodia should focus on productive transformation rather than growth alone.

The second implication is that Cambodia should promote export diversification. The result that trade openness is insignificant suggests that openness alone is not enough to improve external balance. Cambodia needs to expand the variety and complexity of exports so that external earnings become more stable. Research on export composition shows that what a country exports matters for long-run growth because more sophisticated export structures are associated with stronger future economic performance (Hausmann et al., 2007).

The third implication is that inflation control should remain a key macroeconomic priority. The long-run negative effect of inflation on the current account suggests that price instability can damage external competitiveness. Cambodia should therefore maintain prudent fiscal management, improve domestic supply capacity, and reduce cost pressures in production. Inflation management is especially important for an open economy because domestic price increases can affect both import demand and export competitiveness.

The fourth implication concerns FDI policy. Since FDI has a positive but insignificant long-run effect on the current account, Cambodia should not focus only on attracting more FDI, but also on improving the quality of FDI. Investment should be directed toward export-oriented industries, domestic value-chain development, technology transfer, and productivity improvement. Evidence from developing countries shows that FDI can

either crowd in or crowd out domestic investment depending on local conditions and the structure of investment (Agosin & Machado, 2005).

The fifth implication is that Cambodia should reduce import dependence by strengthening domestic production capacity. The short-run negative effects of GDP growth and savings suggest that economic expansion increases import pressure. Policies that support local suppliers, small and medium-sized enterprises, domestic agro-processing, and industrial linkages can help reduce the import content of growth. This does not mean Cambodia should restrict trade, but rather that the country should increase domestic value added within export and investment activities.

The sixth implication is that external adjustment policy should consider both trade and financial channels. The insignificant FDI result indicates that capital inflows do not automatically solve current account problems. Studies on financial globalization show that the growth benefits of external finance are not always automatic and depend on domestic institutions, financial development, and policy frameworks (Kose et al., 2009).

Comparison with Literature

The positive long-run relationship between GDP growth and the current account balance that appeared in the baseline model is not robust once the COVID-19 crisis is accounted for. The revised specification indicates that the previously observed positive association was likely driven by the extreme pandemic-era observations rather than by a stable structural link. However, the negative short-run relationship between growth and the current account remains strong, confirming that Cambodia's growth process initially increases import demand. This result is consistent with research on developing countries showing that current account balances are closely linked to output fluctuations, savings, and investment behavior (Calderón et al., 2002).

The insignificant long-run effect of savings differs from the traditional saving-investment interpretation of the current account, where higher national savings should generally improve the current account. Chinn and Prasad show that current account balances are strongly related to macroeconomic determinants of saving and investment across countries, but Cambodia's result suggests that the relationship may be weaker in a small open economy where savings are converted into import-intensive investment (Chinn & Prasad, 2003).

The finding that FDI is not statistically significant is consistent with the argument that foreign capital does not always produce stronger growth or external sustainability in developing countries. Prasad et al. argue that nonindustrial countries relying more heavily on foreign finance have not necessarily grown faster in the long run, which supports the idea that the development effect of capital inflows depends on how effectively they are absorbed by the domestic economy (Prasad et al., 2007).

The insignificant effect of trade openness is also consistent with the idea that openness alone does not guarantee external adjustment. Trade openness improves external performance only when export capacity, productivity, and diversification are strong enough to offset import growth. Cadot et al. show that export diversification changes along the development path and that diversification occurs through both intensive and extensive margins, suggesting that countries must broaden their export base to improve trade outcomes (Cadot et al., 2011).

Overall, the results show that Cambodia's current account dynamics are shaped by the structure of growth rather than growth alone. In the long run, economic expansion may improve external balance when it supports production and export capacity, although this effect was not statistically robust in the present study. In the short run, however, growth and savings may worsen the current account because they increase import demand. This confirms the central argument of the study: Cambodia's external adjustment depends not only on macroeconomic expansion, but also on the composition of trade, the quality of FDI, domestic production capacity, and the ability to control inflation.

CONCLUSION AND RECOMMENDATIONS

Summary of Findings

This study examined the relationship between economic growth, trade imbalances, and external adjustment in Cambodia using annual data from 2000 to 2024. The current account balance was used as the dependent variable,

while GDP growth, inflation, gross domestic savings, trade openness, and foreign direct investment served as explanatory variables. The ARDL approach was applied because the unit root results showed that the variables are a mixture of $I(0)$ and $I(1)$. A COVID-19 dummy for 2020-2021 was included to account for the unprecedented structural break in the current account.

The descriptive statistics showed that Cambodia's current account balance averaged -6.28% of GDP, confirming persistent external deficits. GDP growth averaged 7.24% , while trade openness averaged 124.40% of GDP, reflecting Cambodia's high integration into the global economy. FDI inflows averaged 7.63% of GDP, underscoring the importance of foreign capital.

The long-run ARDL results from the revised model indicate that GDP growth carries a positive coefficient (0.6133) but is not statistically significant ($p = 0.293$). This suggests that, once the pandemic shock is controlled for, economic growth alone does not exert a robust long-run influence on the current account. Inflation has a negative and strongly significant long-run effect (-1.0448 , $p = 0.004$), indicating that higher domestic prices systematically worsen the external balance. Gross domestic savings, trade openness, and FDI remain statistically insignificant in the long run, implying that these variables do not have a strong direct effect on Cambodia's current account in this specification.

The short-run results reveal that GDP growth has a negative and significant effect on the current account (-2.0154 , $p = 0.000$), confirming that rapid expansion initially increases import demand. Inflation has a positive short-run effect (0.4056 , $p = 0.010$), while gross domestic savings has a negative short-run effect (-1.8302 , $p = 0.001$). The error correction coefficient is -0.7641 and significant at the 1% level, indicating that approximately 76.4% of disequilibrium is corrected within one year. The COVID-19 dummy is highly significant (-14.8804 , $p = 0.002$), capturing the extraordinary deterioration of the current account in 2020-2021.

Diagnostic tests on the revised model show that the residuals are normally distributed, there is no heteroskedasticity, and serial correlation – which was present in the baseline specification – has been fully eliminated (Breusch-Godfrey $p = 0.3292$). Multicollinearity remains acceptable. The revised model therefore passes all misspecification checks and is preferred over the baseline.

Conclusion

The findings of this study show that Cambodia's external adjustment process is shaped by both growth dynamics and structural features of the economy. The revised evidence indicates that, after controlling for the pandemic shock, GDP growth does not exert a statistically significant long-run effect on the current account balance, although it continues to worsen the external balance in the short run through higher import demand. This difference suggests that Cambodia's growth process creates immediate import pressure before the benefits of higher production capacity and export expansion are fully realized. Therefore, growth alone is not sufficient to guarantee external stability; the structure and quality of growth are equally important.

Inflation plays an important role in Cambodia's external balance. The long-run negative effect of inflation suggests that price instability can weaken competitiveness and worsen the current account balance. Although inflation showed a positive short-run effect, this should not be viewed as a desirable policy outcome because persistent inflation may damage export performance and reduce macroeconomic stability over time.

The insignificant effects of FDI and trade openness suggest that Cambodia's integration into global markets does not automatically improve the current account balance. FDI can support growth and investment, but its contribution to external adjustment depends on whether it strengthens export capacity and domestic value-added production. Similarly, trade openness can improve the current account only when export growth is strong enough to offset import expansion.

Overall, the study concludes that Cambodia's external adjustment depends on transforming growth from an import-dependent model toward a more export-oriented, productivity-driven, and domestically linked structure. The strong and significant error correction term indicates that Cambodia's current account balance adjusts relatively quickly after shocks, but sustainable improvement requires deeper structural reform.

Policy Recommendations

Cambodia should strengthen export-oriented growth by supporting sectors that generate stable foreign exchange earnings. Policy should focus on expanding higher-value manufacturing, agro-processing, tourism services, and digital trade. Export diversification is important because reliance on a narrow range of export products can expose the country to external shocks and weaken current account stability.

The government should reduce import dependence by improving domestic production capacity. This can be achieved through support for small and medium-sized enterprises, local supplier development, industrial linkages, and investment in domestic input production. Reducing the import content of growth would help ease pressure on the current account during periods of rapid economic expansion.

Cambodia should improve the quality of FDI rather than focusing only on the quantity of inflows. FDI should be encouraged in export-oriented industries, technology transfer, skills development, and sectors that increase domestic value added. Investment incentives should prioritize projects that strengthen local production networks and reduce excessive dependence on imported inputs.

Macroeconomic stability should remain a central policy priority. Since inflation has a negative long-run effect on the current account balance, Cambodia should maintain prudent fiscal policy, strengthen price monitoring, and improve supply-side capacity to reduce inflationary pressure. Stable prices would help protect export competitiveness and support external balance.

Trade policy should focus not only on openness but also on competitiveness. Cambodia is already highly open to international trade, but openness alone does not guarantee current account improvement. The country should improve trade facilitation, logistics, infrastructure, customs efficiency, and product quality standards to make exports more competitive in regional and global markets.

Domestic savings should be mobilized more effectively toward productive investment. Since savings had a negative short-run relationship with the current account, policy should ensure that savings are directed toward sectors that build export capacity rather than only import-intensive activities. Financial sector development can help channel savings into productive domestic industries.

Limitations and Future Research

This study has several limitations. First, the sample size is relatively small because the analysis uses annual data from 2000 to 2024, giving only 25 observations. Although the ARDL approach is suitable for small samples, a larger dataset could provide stronger statistical reliability.

Second, the model uses aggregate macroeconomic variables and does not include sector-specific data. Cambodia's current account balance may be influenced differently by FDI in garments, construction, agriculture, tourism, and real estate. Future research could examine sectoral FDI and sectoral trade data to provide a more detailed explanation of external adjustment.

Third, the initial baseline model exhibited serial correlation (Breusch-Godfrey $p = 0.0069$). This issue was fully resolved by including a COVID-19 crisis dummy for 2020-2021, confirming that the autocorrelation stemmed from the pandemic structural break rather than from dynamic misspecification. Future studies could apply formal structural break tests (e.g., Bai-Perron) or use a Nonlinear ARDL (NARDL) approach to examine possible asymmetries in the adjustment process during crisis periods.

Fourth, this study does not directly include exchange rate variables, external debt, foreign reserves, remittances, or global shock indicators. These factors may also influence Cambodia's current account balance and external adjustment. Future research should include these variables to develop a more comprehensive model of external sector dynamics.

Finally, future studies may compare Cambodia with other ASEAN economies to determine whether Cambodia's external adjustment process is similar to or different from neighboring countries. A regional comparison would

help identify whether Cambodia's trade imbalance is mainly country-specific or part of a broader pattern among small open developing economies.

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