AMRO Annual Consultation Report

Cambodia - 2017

The ASEAN+3 Macroeconomic Research Office (AMRO)

December 2017

Acknowledgements

1. This Annual Consultation Report on Cambodia has been prepared in accordance with the functions of AMRO to monitor, assess and report its members' macroeconomic status and financial soundness and to identify the relevant risks and vulnerabilities, and assist them, if requested, in the timely formulation of policy recommendation to mitigate such risks (Article 3(a) and (b) of AMRO Agreement).

2. This Report is drafted on the basis of the Annual Consultation Visit of AMRO to Cambodia from 22 to 28 June 2017 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr Seung Hyun (Luke) Hong, Group Head and Lead Specialist. Members include Dr Xianguo Huang (Economist), Dr Pum Huot (Economist), Dr Abdurohman (Specialist), Ms Siti Athirah Ali (Researcher), Ms. Vanne Khut (Associate), and Mr Oudom Cheng (Associate). AMRO Director Dr Junhong Chang and Chief Economist Dr Hoe Ee Khor also participated in key policy meetings with the authorities. This AMRO Annual Consultation Report on Cambodia for 2017 was approved by Dr Hoe Ee Khor, AMRO Chief Economist.

3. The analysis in this Report is based on information available up to 15 September 2017.

4. By making any designation of or reference to a particular territory or geographical area, or by using the term "member" or "country" in this Report, AMRO does not intend to make any judgements as to the legal or other status of any territory or area.

5. On behalf of AMRO, the Mission team wishes to thank the Cambodian authorities for their comments on this Report, as well as their excellent meeting arrangements and hospitality during our visit.

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Executive Summary

Since the 2016 Annual Consultation Report, the Cambodian economy has maintained stable growth, supported by solid construction activities and a recovery in agriculture. Garment sector growth continues to slow down while strong tourist arrivals continue to support economic growth in 2017. Inflation, which edged up in 2016, continued to rise in Q1 2017 but softened in the second quarter. The authorities have embarked on an expansionary fiscal policy to support the economy in the face of potential external headwinds. AMRO supports the expansionary fiscal policy while spending efficiency and various policy priorities are properly addressed. Macro-prudential policies are encouraged to safeguard financial stability.

Cambodia's economy is expected to maintain a stable growth rate in 2017 and 2018, supported by tourism and construction activities. Cambodia's GDP growth remained steady in 2016 due to solid activity in the construction sector and a recovery in agriculture. The garment sector grew more slowly and tourist arrivals softened last year. While the slowdown in the garment sector continues, stable growth in construction and a rebound in tourism will help to offset the effects of the slowdown. We forecast the Cambodian economy to grow at 6.9 percent and 6.8 percent in 2017 and 2018 respectively.

The overall external position is expected to remain strong this year. Reflecting the reduction in trade deficit, the current account deficit narrowed from 9.4 percent of GDP in 2015 to 8.9 percent in 2016. Financial inflows were supported by an uptick in FDI inflows, especially to the financial sector, due to the effects of a new regulation on capital requirements. The current account is expected to improve further in 2017 with a rebound in tourist arrivals. However, the capital and financial account surplus may narrow going forward with lower commercial banks' net external borrowing and slower FDI inflows to the financial sector. It is projected that the overall surplus in the balance of payments will be maintained at around 3.6 percent of GDP in 2017.

Headline inflation may increase further to 3.3 percent in 2017. Headline inflation increased to 3.0 percent in 2016 and 3.5 percent in H1 2017 driven by increasing oil prices but is expected to moderate in H2 2017.The inflation in 2018 is expected to be stable around 3.5 percent.

While deposit growth has remained stable, credit growth has been slowing down in 2017. For deposit-taking microfinance institutions (MDIs) and other microfinance institutions **(**MFIs), loan growth declined from 37.3 percent at the end 2015 to 13.1 percent at the end of 2016. Going forward, the overall credit growth is likely to remain soft with the continuing implementation of regulations. While most financial indicators have remained sound, NPL ratios—especially those at MFIs—increased.

The overall fiscal position has been improving with sustained tax revenue growth, although a higher deficit is budgeted in 2017. Central government's tax revenue grew by 12.5 percent in 2016, while current expenditure grew by 23.4 percent. The overall fiscal deficit (excluding grants) stood at 3.4 percent of GDP in 2016, lower than the 5.6 percent average during 2011-2015. While tax revenue is expected to increase further in 2017, a larger fiscal deficit is planned in 2017 to support growth.

Main downside risk stems from weakening competitiveness. The regular minimum wage hikes in the garment sector have increased the wage floor from USD80 in 2013 to USD153 in 2017, which has significantly affected the industry's labor-cost competitiveness.

U.S. Dollar movements and losing preferential treatment status in trade and external financing can increase downside risks. Given its highly dollarized economy, Cambodia's export sector could be adversely affected by a strengthening of the US dollar. With the expected graduation from Least Developed Countries (LDC) status in a few years and the implementation of EU-Vietnam Free Trade Agreement (FTA), Cambodia's exports will face more competition in the European market. Cambodia may also lose its eligibility for concessional funding for projects when its economic status is upgraded.

Risks to financial stability may come from various fronts. While slower credit growth helps to reduce risks to overall financial stability, the quality of the loan portfolio should be closely monitored. The domestic financial system is vulnerable to shocks from the global financial market because of its heavy dependence on external funding. The excess supply of high-end residential segment may pose risks of potential spillover.

As a small and highly open economy, Cambodia needs to maintain its external competitiveness in order to sustain high growth in the medium term. While wage increases should be in line with underlying productivity growth, offsetting past wage hikes requires that Cambodia continues its efforts to improve its competitiveness across other dimensions including trade facilitation, logistics improvement and reducing electricity costs.

Managing public resources to address priority needs is critical. Improving public sector capacity and rebalancing budget allocation towards more capital investment are essential to enhance growth prospects. Strong revenue increase and fiscal prudence will help to build a fiscal buffer to support stable growth. Authorities should also consider diversifying financing sources to sustain infrastructure spending and boost spending efficiency.

Continued vigilance over the financial system through sound prudential policies and enhanced supervision would help to maintain financial stability. With monetary policy constrained by dollarization, a comprehensive framework of prudential measures will help to manage risks in the financial system. More active management of liquidity risks will improve financial stability and exchange rate stability. Supervisory capacity also needs to be strengthened further to cope with the large number of banks and MFIs, as the need for timely assessment and policy calibrations is rising. Building sufficient foreign reserves as a buffer against external financial risks and domestic liquidity shocks is essential.

A. Recent Developments and Outlook

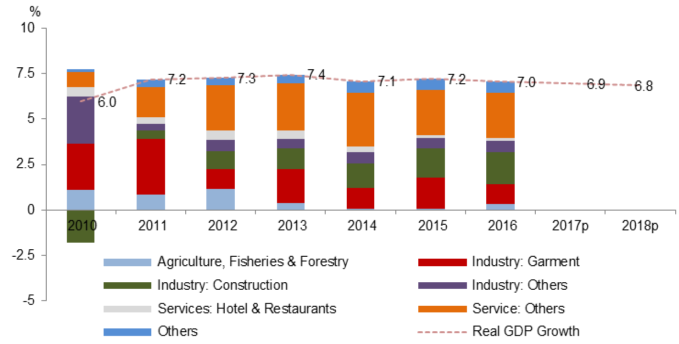
A.1 Real Sector

1. **Cambodia's GDP growth remained stable in 2016 due to robust construction activity and a recovery in agriculture.** According to the official estimate, GDP growth in 2016 stood at 7.0 percent, compared to 7.2 percent in 2015. Despite a gradual slowdown in garment export growth, a robust construction sector and recovery in agriculture supported overall growth in 2016.

2. **Agriculture and fisheries recovered in 2016.** The agriculture, fisheries and forestry sector recovered somewhat in 2016, rebounding from around 0.7 percent growth during 2013-2015 to 1.4 percent in 2016.[1] Crops, which account for half of the sector, grew by 2.2 percent in 2016 compared to 0.3 percent in 2015. Fish production recovered after years of contraction, seeing both positive growth rates in terms of both export volume and value, registering 12.6 percent growth in quantity and 35.3 percent in value last year.

3. **In the industrial sector, the garment industry grew more slowly**. The garment industry, including clothing, footwear and other textiles, is the largest employer in the formal sector and accounted for 73.1 of export value in 2016.[2] The real GDP data suggested that this sector grew slower to 6.2 percent in 2016 compared to 9.8 percent in 2015.

Real GDP Growth



Source: National Institute of Statistics, AMRO staff calculations

4. **Construction activities remained robust with the prospect of an increasing number of approved projects**. The construction sector grew by 20.4 percent in 2016, supported by strong growth in loans.[3] Across sectors, 2,636 projects—an increase of 27.3 percent in number (188.3 percent increase in sqm) and 255.9 percent in value—secured approval from the Ministry of Land and Urban Planning in 2016. Residential and commercial projects accounted for 77.8 percent and 10.4 percent of all approved projects respectively. While data on the actual implementation of construction is not available, the sector is likely to continue to see strong growth in the short-term.

[1] This sector's share of GDP has declined over time to reach 20.1 percent of GDP in 2016.
[2] According to the International Labour Organization, the sector employed 605,000 workers in 2016. According to the Cambodian Socio-Economic Survey 2014, out of a working age population of 10.0 million, 8.3 million people were in the workforce.
[3] Construction loans accounted for around 10.0 percent of total corporate loans by commercial banks. They grew by 42.1 percent in 2016 compared to 10.6 percent in 2015. The high loan growth to construction in 2017 was partly due to the lower base in 2016.

5. **Other manufacturing activities grew with support from domestic demand and rising sales prices.** For instance, food and beverages manufacturing started to pick up, growing by 6.9 percent, above the average of 2011-2016, and will grow further with investments in this sector trending up. Rubber production could increase with the price recovery in the international market in 2017.

6. **Tourist arrivals grew more slowly and tourist spending per capita was stable in 2016.** Tourist arrivals in 2016 surpassed 5.0 million, registering 5.0 percent growth, slightly lower than the 6.0 percent growth seen in 2015.[4] Despite the strong U.S. Dollar, the average spending increased by 1.6 percent in 2016, which helped total receipts reach USD 3.2 billion, compared to USD 3.0 billion in 2015.

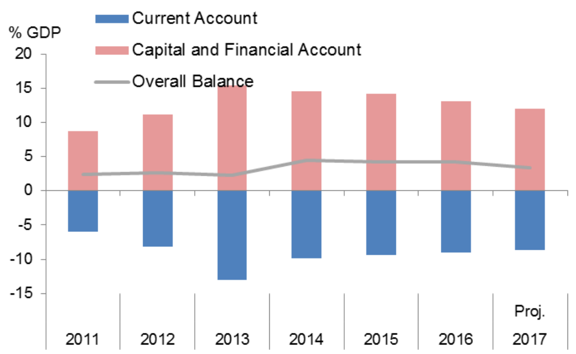
7. **Going forward, Cambodia's economy is expected to maintain stable growth in 2017 and 2018, supported by tourism and construction.** The export data for first five months of 2017 suggests that the garment sector continued to decelerate and grew at a slower pace than in the past. However, with more direct flights to the region and other travel facilitation measures, there was a strong rebound of tourist arrivals by 12.5 percent in the first five months of 2017, compared to 2.4 percent in the same period last year.[5] Meanwhile, ongoing efforts to upgrade tourism infrastructure mean that the tourism sector's prospects remain bright, and this will support demand across various service sectors. Growth support from agriculture, which is subject to weather conditions in the short-term, remains uncertain in 2017. Taking all these factors into account, Cambodian economy will grow at 6.9 and 6.8 percent in 2017 and 2018 respectively.

A.2 External Sector

8. **The overall external position continued to be strong with a narrowing current account deficit and sustained financial account surplus.** The current account deficit as a percentage of GDP declined from 9.4 percent in 2015 to 8.9 percent in 2016. In particular, the goods trade deficit narrowed, as the slowdown in both export- and consumption-related imports were greater than the decline in export growth.[6] Financial inflows were supported by an uptick in FDI inflows. Owing to a new regulation on capital requirements of both commercial banks and MFIs, FDIs into the financial sector in 2016 grew strongly by 25.4 percent while FDIs into other sectors remained patchy. On the other hand, commercial banks' net borrowing dropped substantially from 2015, partly reflecting softening domestic private credit growth and repayment of short-term funding.

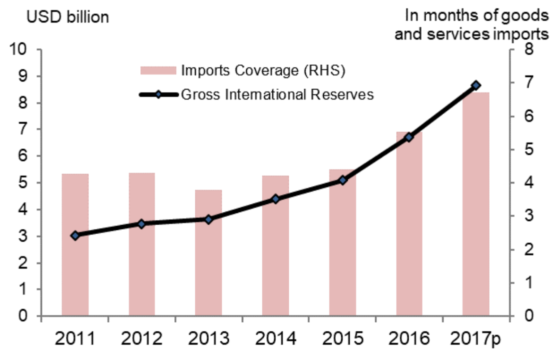
[4] The growth in tourist arrivals from mainland China remained robust, growing by 19.5 percent in 2016, and accounting for 16.6 percent of all tourist arrivals. This growth offset the fewer number of tourists arriving from other East Asian economies and slower growth in the number of visitors from the ASEAN region.
[5] The Ministry of Tourism targets more than 5.5 million tourist arrivals by end-2017, a minimum increase of 10.0 percent compared to the 2016 figure. With the implementation of its "China Ready" strategy to gain from the current boom of Chinese outgoing tourists, it expects 7.0 million tourist arrivals by 2020.
[6] The import substitution such as increasing domestic production of cement and beverage also attributed to import growth deceleration.

Balance of Payments



Source: National Bank of Cambodia (NBC)

International Gross Reserves



Source: NBC

9. **The trade deficit is likely to remain stable.** We expect garment exports to remain under pressure owing to increasing domestic labor costs and competition from neighboring countries. However, this will be offset somewhat by emerging export opportunities such as travel-related goods.[7] Agriculture products such as rice may face headwinds when the E.U. sets up a higher import standard, although exports to China will likely continue to increase.[8] The growth of retained imports for domestic use, other than re-export items for the garment sector, has been contained as imports such as high-end vehicles have become more expensive due to the increased excise tax, also affecting fuel imports.

10. **The current account deficit is expected to narrow further in 2017.** In addition to the stable trade deficit, the service account surplus is expected to improve further due to a rebound in tourist arrivals. Current transfers increased substantially due to statistical improvements capturing private remittances, while the net income deficit remains flat.[9] As a result, the current account deficit is likely to narrow further from 8.9 percent in 2016 to 8.4 percent and 8.3 percent in 2017 and 2018 respectively.

11. **Reflecting lower FDI inflows and commercial banks' net borrowing, the capital and financial account surplus is expected to narrow going forward.** The large increase in FDI into the financial sector, which grew by 25.4 percent and accounted for 33.4 percent of total FDI, was mainly driven by regulatory changes and is not likely to be sustained. Real estate investment projects from China [10] and infrastructure projects under the "One Belt, One Road" initiative, may increase significantly but they are unlikely to materialize in the near term. On the other hand, net external borrowings of domestic banks may be reduced with slowing domestic credit and more domestic

[7] According to Garment Manufacturers Association in Cambodia (GMAC), the number of travel luggage factories doubled to 30 with total exports worth USD250.0 million in H1 2017, compared to USD110.0 million and USD50.0 million for the whole of 2016 and 2015 respectively.
[8] The interational prices of rice and rubber have showed some signs of stabilization in recent months.
[9] The expansion of the International Transactions Reporting System (ITRS) coverage will further minimize the errors from commercial banks and thus improve data quality and accuracy going forward.
[10] Two projects with a total value of USD4.2 billion were signed between December 2016 and January 2017 but their implementations remain uncertain.

deposit funding. The capital and financial account surplus-to-GDP is projected to narrow from 13 percent in 2016 to 11.9 percent and 10.6 percent in 2017 and 2018 respectively.

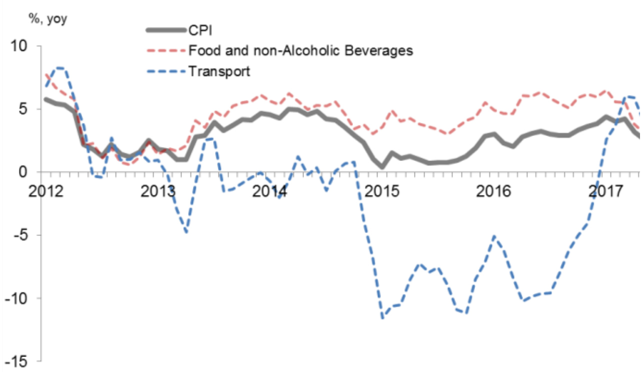
12. **The overall balance of payments surplus will continue to support the accumulation of international reserves.** Gross international reserves increased by around USD700 million in H1 2017, to reach USD7.9 billion—covering around six months of goods and services imports. The overall surplus is projected at 3.6 percent and 2.3 percent of GDP in 2017 and 2018 respectively.

A.3 Inflation and Exchange Rate

13. **Headline inflation increased to 3.0 percent in 2016.** Food inflation, which has the highest weight in the Consumer Price Index (CPI) basket, increased to 5.6 percent in 2016, 1.6 percentage points higher than in 2015. The negative contribution of fuel-related items continued but became smaller, changing from -1.7 percent in 2015 to -1.1 percent in 2016.

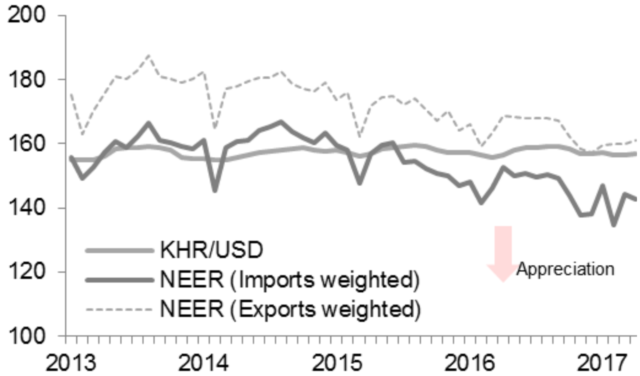
14. **Headline inflation is forecast to increase further to 3.3 percent in 2017 with a positive contribution from domestic oil prices.** In H1 2017, the average monthly yoy change of CPI stood at 3.5 percent, with food- and fuel-related inflation at 4.5 percent and 4.2 percent, respectively. The good rice harvest in Q2 has dampened the increase of rice prices but likely to be temporary.[11] Due to the base effect, the contribution of fuel-related items to the overall inflation will likely be positive.

CPI Inflation



Source: NBC

Exchange Rate



Note: index starts from Jan 1996 (=100)
Source: Bloomberg, IMF, and AMRO staff estimates

15. **The exchange rate remained stable against the U.S. Dollar.** The month-on-month changes in the KHR/USD exchange rate remained stable, fluctuating within a small +/- 1.0 percent band through 2016 and H1 2017. The nominal effective exchange rate appreciated during H2 2016 as a

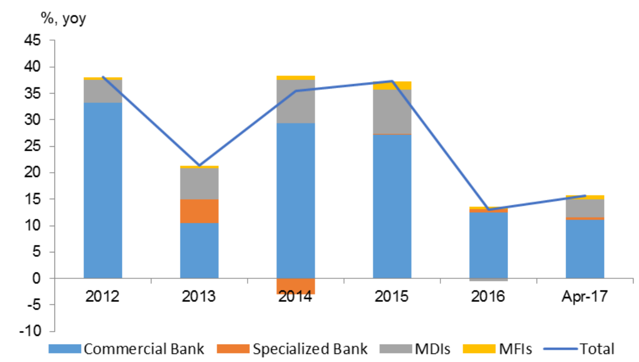
[11] With government's signed deal to export 250,000 tons of milled rice to Bangladesh in August 2017, food inflation could be likely stabilized in the rest of years. Meanwhile, the government decision to intervene the market, announced in August, will help to stabilize the market.

result of the strong U.S. Dollar. In H1 2017, it started to depreciate somewhat as the US dollar weakened.

A.4 Financial Market

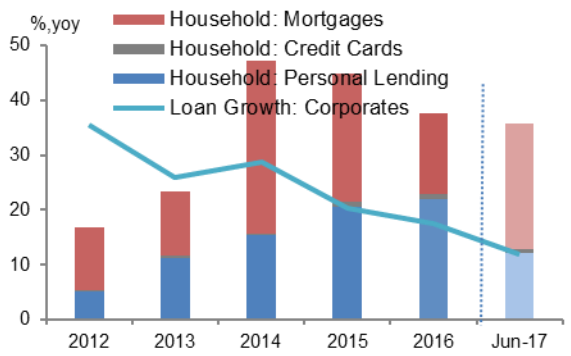
16. Credit growth has continued to slow down in 2017. Total loan growth, including commercial and specialized banks, MDIs and other MFIs, declined from 37.3 percent at the end 2015 to 13.1 percent at the end of 2016.[12] In terms commercial banks' loan by sector, corporate loan growth slowed to 11.9 percent as of June 2017 from 17.5 percent in 2016, although household loan—especially mortgages—continued to be elevated. The overall credit growth slowdown is partly due to the changes in the minimum capital requirement and liquidity coverage regulations. Going forward, the overall credit growth is likely to remain soft with the continued implementation of regulations.[13]

Loan Growth in the Whole System



Source: NBC

Loan Growth of Commercial Bank



Source: NBC

17. **Despite moderating credit growth, deposit growth in the economy remained stable, resulting in lower loan-to-deposit (LTD) ratio.** Total deposit growth at all banks and MFIs stayed stable at 18.5 percent at the end of 2016, compared to 19.0 percent a year earlier. Excluding the effects of the merger between Sathapana Microfinance and Maruhan Bank, deposit growth at commercial banks and MFIs was estimated at 16.0 percent and 48.0 percent respectively, in 2016. The LTD ratio of banks and MFIs stood at 111.0 percent and 208.0 percent in 2016 respectively, compared to 114.0 percent and 228.0 percent in 2015. The residents' deposit growth remained stable in 2017, standing at 19.9 percent as of end-June 2017 compared to 19.3 percent in the same period last year.

[12] These numbers do not control the transition effect of Sathapana bank from MFI to commercial bank in March 2017. Therefore, the growth of commercial banks and underestimated that of MDIs in 2016 are somewhat overstated.

[13] The new capital regulation has increased the minimum registered capital of MDIs from around USD2.5 million to USD30.0 million and of MFIs from around USD 62,500 to USD1.5 million. This requires to increase the capital by half of the difference between the actual capital and new minimum registered capital at the latest by end-March 2017 and in full by 22 March, 2018. The minimum liquidity coverage ratio (LCR) for commercial banks and deposit-taking MFIs is to be phased-in from 60.0 percent from 1 September 2016 to reach 100.0 percent by January 2020.

18. **While most of the financial indicators have remained broadly sound, NPL ratios, especially those of MFIs, increased.** Although the NPL ratios of commercial banks and MFIs have remained low, they increased from 1.9 percent to 2.4 percent and from 0.8 percent to 1.4 percent respectively, in 2016. In Q1 2017, the NPL ratio at MFIs continued to increase while that of banks stabilized [please see more details in Box 1: The Microfinance Sector in Cambodia]. The reported capital adequacy ratios of banks and MFIs stood at 22.0 percent and 21.7 percent respectively as of end-2016, remaining broadly stable throughout the year.

19. **The financial sector is becoming more developed with the adoption of new technology and products.** Although at a nascent stage, the increasing adoption of electronic payment technology and credit cards for payments has helped to promote financial inclusion in Cambodia. On the other hand, the insurance sector has been growing very fast in recent years with provisions of multi-tier insurance products, albeit from a low base. Starting from 2016, derivative trading has become more popular with the availability of futures contracts in precious metals and foreign exchange. The authorities are planning to establish the corporate bond market in the near future to allow local firms to tap alternative financing and optimize their capital structures.

A.5 Fiscal Sector

20. **Tax revenue is expected to increase further in 2017 especially with the rapid growth in direct tax collection.** Central government's tax revenue grew by 12.5 percent in 2016, although growth was slower than the 20.0 percent average during 2012-2015. With continuing efforts in tax administration under the Revenue Mobilization Strategy (RMS) such as compliance in the registration of payroll ledgers and employment cards, direct taxes—including personal income tax, corporate income taxes, and land and property taxes—rose further as a share of tax revenue, from 16.8 percent in 2010 to 24.2 percent in 2016 [please see more details in Box 2: Tax System Dynamism in Cambodia]. As of H1 2017, around 73.7 percent of direct tax revenue has been achieved compared to the budget figure, higher than the 54.6 percent achieved in the same period last year. This significant increase is expected to offset the decline in import duties as a result of free trade agreement compliance and should drive strong revenue growth in 2017.

21. **Faster growth in current expenditure than in revenue has narrowed the scope for scaling up capital expenditure.** Current expenditure grew by 23.4 percent in 2016, accounting for 66.4 percent of total public expenditure in 2016, up from 63.6 percent in 2015 and 51.5 percent in 2010. The faster growth in current expenditure has reduced the current budget balance surplus which is used to finance domestic capital projects.

Tax Revenue: Growth Contribution and Share (%)

Growth Contribution	2013	2014	2015	2016	2017p	2018p
Tax Revenue	13.1	28.1	16.1	12.5	19.4	9.6
Indirect Taxes	6.2	17.2	9.3	8.1	8.3	5.7
Int'l Trade Taxes	2.5	5.4	1.3	0.0	-1.0	-0.6
Direct Taxes	4.4	5.5	5.4	4.4	12.1	4.6
Share						
Indirect Taxes	58.1	58.8	58.7	59.3	56.6	56.8
Int'l Trade Taxes	20.5	20.2	18.5	16.5	13.0	11.3
Direct Taxes	21.4	21.0	22.8	24.2	30.4	31.9

Note: Data based on TOFE

Source: MEF and AMRO staff projections

22. **In addition to limited domestic resources to finance capital expenditure, other factors have constrained the increase in capital spending as well.** The amount of capital spending financed by domestic resources has been low in Cambodia, averaging 2.4 percent of GDP during 2011-2016. External financing, therefore, has provided the greater part of the financing for Cambodia's capital formation, especially in terms of infrastructure investment. Total public capital spending—although increasing in absolute terms—has decreased from 9.7 percent of GDP to 7.7 percent of GDP during 2013-2016. This has reflected in part the authorities' concern over the spending inefficiency of self-administered projects.

23. **The overall fiscal position has continued to improve, with the buildup of fiscal reserves.** The overall fiscal deficit (excluding grants) stood at 3.4 percent of GDP, lower than the average 5.6 percent of GDP during 2011-2015. Although the fiscal deficit to GDP has edged up slightly compared to 2015, it was driven mainly by the improved disbursement of capital spending. Continuing government cash net inflows contributed to the accumulation of government deposits in 2016 to 10.5 percent of GDP.

24. **The debt profile remains sound.** According to World Bank estimates, total external debt in Cambodia stood at 51.5 percent of GDP as of end-2015, of which two-thirds was public debt with medium- to long-term maturity. We estimate that the public debt, which is mostly external, declined to 30.3 of GDP in 2016, and expect it to remain stable in 2017 and 2018. Although the debt service burden—including principal and interest payments— is projected to edge up in value annually, it will remain low, peaking at 1.1 percent of GDP in 2020, given that almost the entire public debt stock has medium-to-long term maturities and concessional interest rates.

Box 1: The Microfinance Sector in Cambodia

Microfinance Institutions (MFIs) have been growing rapidly, contributing to financial deepening. There were 241 MFIs with 4,154 district branches across Cambodia at the end of 2016.[14] With an increase in the number of players and expanding geographical presence, the sector's outstanding loans rose sharply to 15.8 percent of GDP in 2016, compared to just 1.0 percent of GDP in 2005. In comparison, bank loans grew from 8.5 percent of GDP to 70.5 percent over the same period. Such a rapid expansion of the MFI sector has broadened financial access and allowed 3.4 million people or 14.0 percent of the total population, who were mostly living in the rural areas, to tap MFI financing by end-2016.

Despite the rapid expansion, the MFI sector has been able to maintain relatively sound asset quality and equity return in the past decade. The average NPL ratio during 2007-2016 was around 0.8 percent, compared to 2.7 percent for bank counterparts. This could be due to MFIs' unique lending, monitoring, and more frequent bad loans write-off practices. In particular, loan issuance and collection are mainly done on-site, with mostly small and secured loan sizes and flexible repayments based on client cash flows. The return on equity was 16.7 percent during 2007-2016 compared to 10.2 percent for commercial banks in the same period

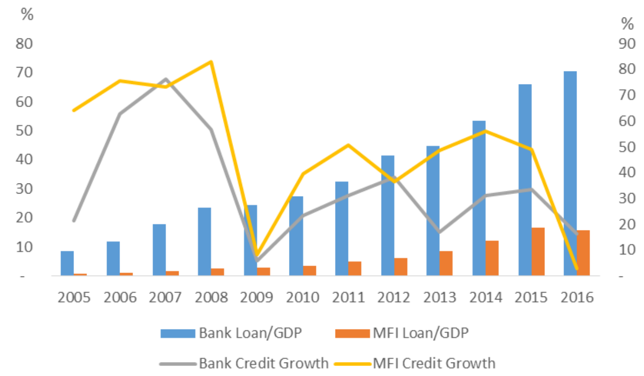
While MFIs' lending rate has decreased somewhat due to competition over time, it remains high as it is constrained by high operational costs. MFIs' average lending rate stood at 28.2 percent for USD loans and 34.0 percent for KHR loans in 2016. Although the rates have edged down somewhat over time, they are still high when compared to the 11.7 percent for USD loans and 16.9 percent for KHR loans charged by commercial banks.[15] Practices such as on-site loan disbursement and repayment collection, on the one hand helping to ensure loan quality, have also led to high operational costs for MFIs. Meanwhile, compared to commercial banks, most of the MFIs are not as sophisticated in terms of using new technology and adopting more efficient management; and although a few large MFIs could tap on domestic deposit funding to scale up lending, most MFIs continue to rely on external funding and are not able to reach economies of scale. All these operations-related factors make it hard for MFIs to lower lending rates as a whole.

There is also an increasing concern of saturation in this sector, which may lead to a rising household indebtedness. With continued high credit growth, the MFI sector shows some signs of crowdedness. Loan penetration over absorptive capacity in this sector, according to our estimate, has reached a very high level and is likely not sustainable. The saturation of the market could be associated with lower lending standards, an increase in the likelihood of multiple loans and orientation towards more consumption loans rather than productive loans for the agriculture sector and micro enterprises.This could aggravate household indebtedness, not a desired outcome given that the original objective of MFIs was to reduce poverty by easing financial access. The NPL ratio, while still low, has started to trend upward, increasing from 0.8 percent as of end-2015 to 2.0 percent in June 2017.

In response, policy efforts have been directed to make the regulatory environment and supervision more stringent, while encouraging MFIs to rely more on domestic funding. While the liquidity coverage ratio imposed by the NBC has helped to strengthen the liquidity profiles of deposit-taking MFIs (MDIs), the minimum capital requirements for both MDIs and other MFIs have been raised to increase the buffer against solvency risks going forward. The NBC has also been encouraging MFIs to join Liquidity Providing Collateralized Operations (LPCO) and allowing them to borrow from domestic commercial banks bilaterally, reducing the external funding exposure and overall funding costs.[16] As the decrease in MFIs' lending rate has been more gradual than what the authorities expected, the administrative interest rate cap was announced and has come into effect since April 2017. The cap may lead to faster evolution—likely consolidation—of this sector going forward, given the apparent heterogeneity in the sector in terms of their funding costs, lending rates before the cap, and efficiency levels.

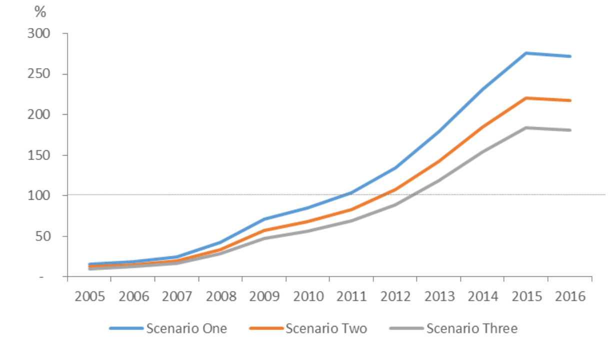
While supportive of the measures to further develop this sector in a healthy manner, AMRO also encourages further differentiation between different groups of MFIs. For example, various differentiation policies can be drawn for MFIs which provide small loans and focus on agricultural-productive loans and for MFIs which have become more commercialized with the more comprehensive business model. Such differentiation should be in terms of their capital requirements, but also more broadly, in terms of the collateral requirements on their access to LPCO, their exposure to bank borrowings, and other factors. Also, collaborating with other nonbank regulators and enhancing supervision is essential to reduce policy and supervision arbitrages between more formalized, licensed MFIs, registered MFIs, pawn shops and other micro creditors. Ultimately, encouraging financial deepening and safeguarding for financial stability should go hand-in-hand, contributing to sustainable and inclusive economic growth.

Credit has been expanding rapidly for both commercial banks and MFIs…



Note: A big MFI was transformed into a bank and reduced the base of MFIs in 2016, which caused the dip in credit growth in 2016.
Source: NBC

…and the MFI sector may be overcrowded as suggested by the Market Saturation Index[17]



Source: NBC, AMRO estimates

[14] Compared to 15 licensed and 23 registered MFIs in 2005, there were 71 licensed and 170 registered MFIs in 2016, out of which 7 are licensed Deposit-taking MFIs. Sathapana Microfinance Plc, one of the biggest MDIs, merged with Maruhan Japan Bank and was renamed as Sathapana Bank in May 2016. The branch networks of MFI sector also expanded significantly from 488 branches in 2005 to 4,154 district branches as of December 2016.

[15] In 2007, the average MFI lending rates were 29.2 percent for USD loans and 38.8 percent for KHR loans.

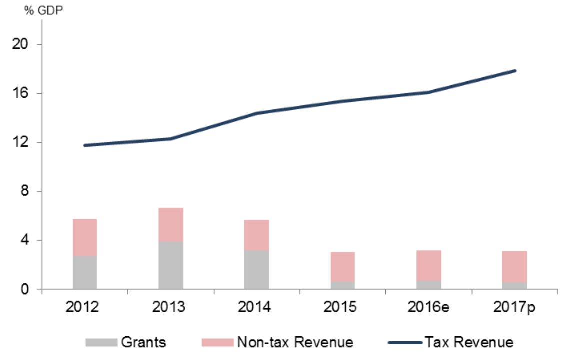
[16] LPCO is an auction mechanism that allows commercial banks and MFIs to bid for a certain amount of KHR within the amount set by the NBC. To qualify as an auction member, banks and MFIs are required to pledge NCDs as collateral at the NBC after winning the bid.

[17] Following Kappel, V., Krauss, A., & Lontzek, L. (2010) and Rozas, D. (2009), the Saturation Index is the number of MFI borrowers divided by the number of potential borrowers. The potential borrowers are those who are targeted by MFIs, particularly the proportion of the poor population (based on the World Bank Poverty Rate at the National Poverty Line) that are of working age between 15–64 years old. Three scenarios are assumed: 1) 60% of the poor working-age population would take micro credit; 2) 75% of the poor working-age population would take microcredit, and 3) 90% of the poor working-age population would take microcredit.

Box 2: Tax System Dynamism in Cambodia

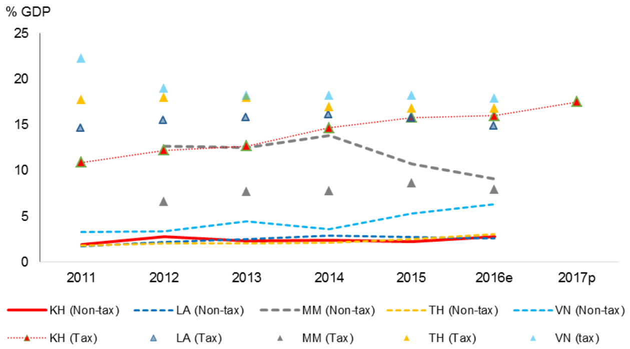
Cambodia has been successful in enhancing its tax revenue collection mainly through administrative efforts in the past three years. The implementation of the Revenue Mobilization Strategy (RMS) 2014-2018, focusing on strengthening revenue administration and tax compliance, increased the tax revenue from 12.3 percent of GDP in 2013 to 15.9 percent in 2016. This increase in tax revenue has been broad-based, with the increase in both direct and indirect taxes, and has been contributed by both tax agencies—the General Department of Taxation and General Department of Customs and Excise. Compared to neighboring countries, tax revenue as a share of GDP in 2016 was higher than in Myanmar and Laos, but 0.9 and 2.0 percentage points lower than in Thailand and Vietnam respectively.

Rising tax revenue is compensating for the decline in grant receipts



Source: MEF

Tax revenue may reach its potential soon as it converges with its regional counterparts



Note: Grants excluded from non-tax revenue. KH, LA, MM, TH and VN stands for Cambodia, Laos, Myanmar, Thailand and Vietnam respectively.
Source: National authorities

Sustaining revenue growth requires continued efforts to broaden the tax base.[18] The tax authorities have taken steps in this direction especially through the recent amendment to the Law on Financial Management which has been in effect since January 2017.[19] "The estimated regime"[20] is fully replaced by "the self-assessment regime" (real regime) to increase voluntary compliance further. Meanwhile, with threshold values in the lower tax brackets for both corporate and personal incomes lowered, taxpayers are now categorized into three groups to facilitate more efficient tax collection. To encourage the registration of SMEs, two-year tax holidays will be guaranteed conditional on proper book keeping. All these efforts, including facilitating registration, encouraging compliance and easing the payment process through adopting information technology, are broadening the tax base for sustainable growth in the medium-term, offsetting continuing revenue loss due to tariff reduction owing to FTA compliance.

With potential gains from the tax administration efforts likely reaching its limit in the near future, the recalibration of tax policy is key to sustaining revenue growth and pursuing optimization. A review of tax codes could be prioritized over a shorter time horizon. Except for the changes in excise tax for imports such as luxury goods and environment-related items effective since April 2016, the tax structure has so far remained unchanged. A systematic review of the existing tax structure—including a review of tax incentives to Qualified Investment Projects—compared to regional and international ones, could serve as a starting point to identify critical areas for recalibration. It requires fully utilizing the existing capacity across departments and further developing designated teams for data processing and improvement guidance, tax policy analysis and designs, as well as coordination. Based on this capacity, the analytical framework for revenue forecasting can also be further strengthened. Future tax reforms require continuing revenue enhancement without jeopardizing competitiveness, mindful of the distributive role of tax policies for social welfare, and linking the reforms to a Medium-Term Fiscal Framework going forward.

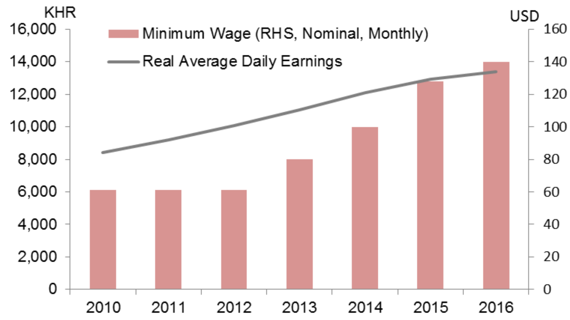
[18] Estimates by the General Department of Customs and Excise suggest that FTAs implementation caused a revenue loss of around USD148.0 million in 2016, while the revenue loss was roughly USD12 million in 2010.
[19] The Law on Taxation was promulgated in 1997 and has been subsequently amended by the annual Law on Financial Management from time to time.

B. Risks and Vulnerabilities

B.1 Risks to Growth

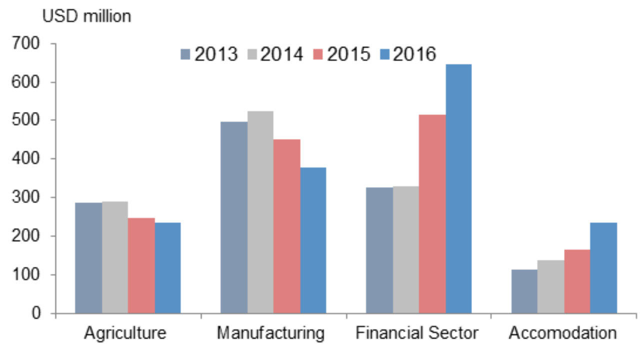
25. **Labor-cost competitiveness in Cambodia has been weakened by substantial minimum wage hikes over the years.** The regular minimum wage increases in the garment sector—labor-intensive and the biggest domestic employer in the formal sector—in the past five years have raised the monthly wage floor from USD80.0 in 2013 to USD153.0 in 2017. These wage increases in the garment sector, have also pushed up the effective wage across sectors, and dampened the prospects of FDI inflows in the sector where the wage increases outpace the underlying productivity gains.

Real Average Daily Earnings and Minimum Wage Hikes[21]



Source: Cambodian Development Resource Institute

FDI Inflows by Sector



Note: Financial sector includes both banks and MFIs. Accommodation includes hotel, resort and casino.
Source: NBC

26. **The upcoming political election in July 2018 may also lead to a "wait-and-see" business sentiment**, which may dampen private investments in the near term.

B.2 Risks to External Position

27. **The growth momentum of Cambodian exports has been stalled by a strengthened U.S. Dollar and devalued British Pound.** The strengthened U.S. Dollar in 2015-2016 vis-à-vis the Euro and the British Pound had dampened European imports from Cambodia, which accounted for 38.8 percent of total exports.[22] Although the U.S. Dollar weakened in H1 2017, it may not be sufficient to change EU importers' expectations of a U.S. dollar appreciation trend at this point, and the slowdown in exports continued in H1 2017, growing at 2.3 percent compared to 12.5 percent for the whole of

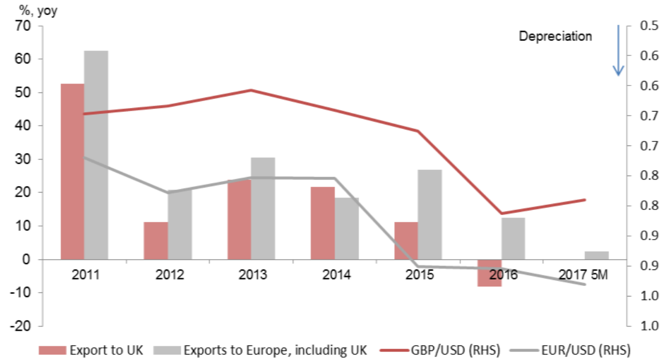
[20] As a compromise of bringing in some tax revenue from untaxed business, the estimated regime applies only to sole proprietorships that fall below a certain threshold on revenue from the sale of goods or services, and has negotiation of tax payment upfront. It was an inefficient regime as a substantial tax force is required to collect only a small fraction of tax revenue.

[21] Average Daily Earnings" were gathered via a quarterly survey by CDRI. The survey, starting from 1998, initially included four selected vulnerable worker groups in Phnom Penh, including cyclo drivers, porters, small vegetable traders and scavengers. Extended since 2000, the survey has included six additional groups. The total sample size is 480 with 120 garment workers and 40 in each of the nine other groups. Respondents for rice-field workers were from Kandaland Kompong Speu province, and the earnings for waitresses do not include meals and accommodations provided by the shop owners. The dataset is average real daily earnings with November 2000 as the base year.

[22] With dollarization, the USD is the currency for exports and major payments in Cambodia.

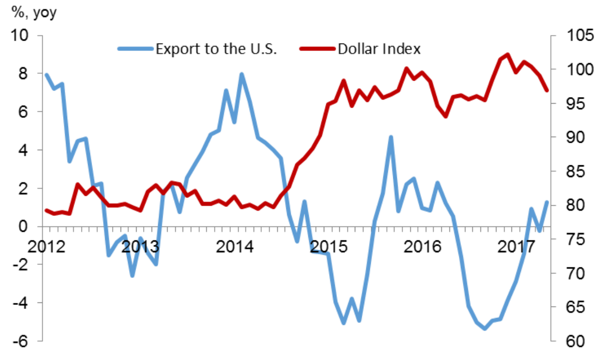
2016. Exports to the U.S. market picked up in 1H 2017, especially for new export items such as travel goods, for which Cambodia has gained a preferential trade treatment since mid-2016. However, this has not been able to fully offset the slowdown in overall exports.

Export to Europe (Value)



Note: Exports to the UK are based on the data of UK imports by country retrieved from World Integrated Trade Solution, and exports to Europe are based on the data from MEF.
Source: World Bank, MEF, and Bloomberg

Export to the U.S. (Value)



Note: Dollar index is retrieved from Bloomberg based on the exchange rates between the USD and major world currencies. Export to the U.S. is a 12-month moving average of monthly export data.
Source: MEF, Bloomberg

28. **Export risks in the medium-term derive from Cambodia's graduation from Least Developed Countries (LDCs) status and the competition from neighboring countries.** The increasing share of exports to the EU area for products such as garments and footwear, have been attributable partly to the preferential treatments toward Cambodian goods imported into the EU, under the "Everything But Arms" agreement. However, with Cambodia expected to graduate from LDCs to lower middle income-country status in a few years, Cambodia will face more competition in the EU market, which has been one of the growth drivers in exports.[23] Meanwhile, the EU-Vietnam Free Trade Agreement, which has been concluded and currently in the process of ratification, could weaken Cambodia further as an attractive destination for the existing and potential investors doing exports.

29. **While low-cost concessional loans are still available, the cost of external borrowing will increase in the medium term.** Cambodia has tapped on low-cost borrowings from multilateral and bilateral development partners for the past two decades. With the country's income level increasing, it is expected that low-cost funding might not be available easily, which Cambodia should be prepared for. With repayment for public debt expected to increase over the next five years, refinancing is expected to become more costly with the transition from low-cost concessional loans to more commercial and domestic financing sources.

[23] The EU's 'Everything But Arms' scheme gives 49 Least Developed Countries duty-free and quota-free access to the EU market for exports of all products, except arms and ammunition. As classified by the UN, the three criteria for graduation from LDCs include Gross National Income (GNI) per capita surpassing USD1,242.0 (the identifying inclusion threshold was USD1,035.0 in 2015 and the graduation threshold is set at 20.0 percent higher than the inclusion threshold), a Human Asset Index (HAI) higher than 66 and an Economic Vulnerability Index (EVI) score of lower than 32. According to Feidouno and Goujon (2016), Cambodia's HAI and EVI reached 63.5 in 2008 and 37.6 in 2013. With the GNI per capita at USD1,070.0 in 2015, Cambodia is expected to meet all graduation criteria in 2018. Upon graduation from LDC status, a three-year grace period could be given.

B.3 Risks to Financial Stability

30. **While slower credit growth helps reduce risks to overall financial stability, the short-term stress on asset quality should be watched.** The NPL ratios for both commercial banks and MFIs are still low, but they have been trending up in tandem with slowing credit growth. At the same time, the expectation of higher lending rates stemming from the U.S. Fed rate hikes and lenders' tighter control on loan rollovers, may contribute to a deterioration of asset quality in some banks and MFIs, which may spill over to the rest of financial sector. The interest rate cap on MFIs, which was implemented in Cambodia in April 2017, may also lead to short-term stress on loan quality with rising loan standards [see more background information on MFIs' development in Box 1].

31. **The high-end residential segment may face pressures stemming from excess supply, with potential spillover effects.** The supply of condominiums is projected to increase sharply in the near future and this will put downward pressure on prices. While continuing to target foreign buyers and offering promotions, developers are now also directing more efforts towards the local market and developing more affordable housing units to meet local demand.[24] If the market cycle turns quickly, followed by a sharp price correction, spillover to other real estate segments and the domestic labor market may lead to distress at those banks which are highly exposed to the real estate. However, as most of the developers and buyers are foreigners who do not finance through the domestic financial markets, the risks arising from this sector are likely to be limited.[25]

C. Policy Discussion

C.1 Sustainable Growth

32. **As a highly open and trade-intensive economy, Cambodia needs to maintain its competitiveness in order to maintain sustainable growth in the medium term.** With policy uncertainties in the U.S., global trade prospects have become more unpredictable. While the demographics in Cambodia remain favorable going forward, the regular minimum wage hikes have increased labor costs and eroded competitiveness in labor-intensive industries. While wage increases should be in line with underlying productivity growth going forward, to offset past wage hikes, Cambodia needs to continue its efforts to improve its competitiveness across other dimensions including trade facilitation, logistics improvement, and reducing electricity costs. Other implicit measures such as tax incentives should also be used to promote industrial diversification and encourage local entrepreneurship, as well as training of employees. In the medium term, one of the

[24] Meanwhile, developers are also eyeing Sihanoukville more closely, an increasingly popular destination for tourism and one that has seen recent industrial developments.
[25] The loan exposure to construction, real estate activities, and housing mortgages accounted around 23 percent of total commercial banks to private sector as of end-2016.

key challenges for growth lies in the enhancing of labor productivity, which requires substantial investment in extending education attainment and vocational training.[26]

33. **Meanwhile, more efforts are required to broaden growth base and diversify economic structure.** The prospects of industrial diversification remain in an earlier stage at this moment. FDI inflows into agriculture and manufacturing remained sluggish in 2016. The overall increase in FDI was driven by commercial banks and MFIs, with new minimum capital requirements, and tourism sector including new hotels and casinos.

C.2 Managing Public Resources to Address Priority Needs

34. **Improving public sector capacity and rebalancing budget allocation towards more capital investment is essential to enhance growth prospects.** In the face of declining competitiveness and a relatively large infrastructure gap, fiscal policy needs to be more supportive of much-needed infrastructure investment and structural reforms. However, limited institutional and human resource capacities are often binding constraints on the effective provision of public goods and efficient allocation of public resources. Therefore, continued efforts to develop public sector capacity are critical to improving efficiency in this rebalancing process.

35. **Strong revenue increase and fiscal prudence have built up a fiscal buffer to support growth.** The successful implementation of RMS has led to strong tax revenue collection and contributed to the trend of declining fiscal deficits for the past few years. On the one hand, the disbursement of spending—particularly current spending—has started to improve, following a temporary drop due to the adoption of program budgeting in 2015 and early-2016. However, the disbursement of domestically-funded public investment spending is still constrained mainly due to absorptive capacity problems. Fiscal policy has been prudent, as reflected in the sizable current surpluses and the annual cap on borrowing, and this has helped to build fiscal space to support economic growth in the coming years. However, the rapid increase in current expenditure needs to be contained from a longer-term perspective, including the concern over its downward rigidity and future policy priorities.

36. **An expansionary fiscal stance will help to support economic growth in the near term.** The authorities plan to scale up capital spending financed by current surplus during 2017-2018, while current expenditure including public wages continues to grow fast. We are supportive of higher capital expenditure to support near-term economic growth, while the efforts to improve the spending

[26] Currently, the authorities have been actively addressing this challenges via the National Technical Vocational Education and Training (TVET) Policy 2017-2025.

efficiency should continue. In addition, public sector wage increase needs to be carefully aligned with the appropriate improvements in the public sector productivity.

37. **Financing sources need to be diversified to sustain infrastructure spending and boost spending efficiency.** Efforts to maintain ODA funding levels and aligning ODA projects with government priorities should continue. Over the medium term, however, alternative sources of financing should be developed in order to maintain or raise capital expenditure to enhance growth potential, along with improved spending efficiency. This can be supported by the development of the domestic capital market and enhancing the framework for the private sector participation.

C.3 Continued Vigilance over the Financial System

38. **With monetary policy constrained due to dollarization, a comprehensive framework of prudential measures should be implemented to manage risks in the financial system.** The domestic interest rates are largely determined by the markets, while the authorities are promoting the usage of local currency [Selected Issue: Dollarization, Inflation and Exchange-rate Based Monetary Policy]. Given the policy constraints, constant review and calibration of macro-prudential policies—related to capital adequacy ratio, liquidity coverage ratio, reserve requirement, loan-to-value ratio, debt service ratio —should be conducted to address systemic and sectoral risks in the economy. In addition, accurate loan classification and detailed information at a disaggregated bank level, and on existing and new borrowers, are needed to further improve the risk assessment in this regard.

39. **The active management of liquidity risks is strongly encouraged to enhance financial and external stability.** The liquidity coverage ratio regulation, which was implemented in early 2016, could serve as an effective tool to monitor potential liquidity risks. There is still room for adjustment in terms of the reserve requirement to fine-tune liquidity in both local and foreign currencies if needed. Conducting liquidity-providing collateralized operations to enhance KHR liquidity and help guide the market-based short-term KHR interest rate will support financial deepening. Meanwhile, maintaining a stable KHR rate against the U.S. Dollar can help reduce the risk of a currency mismatch, while simultaneously promoting the use of the local currency.

40. **Supervision capacity needs to be strengthened further to cope with the larger number of banks and MFIs, and the increasing workload arising from the need for timely assessment and policy calibrations.** Continuing efforts to build supervisory capacity and increasing the number of staff in keeping with the growing size and sophistication of financial institutions are important to ensure timely market communications, proper risk management, and appropriate policy responses.[27]

[27] As of April 2017, the number of the banking supervision staff reaches 62, and the number of the financial institutions reporting to NBC was 112 as of end of 2016.

A forward-looking approach with regular stress-testing and interconnectedness analysis is strongly encouraged.

41. **Building higher foreign reserves as a buffer against external financial risks and domestic liquidity shocks is essential.** It will be prudent for the authorities to continue building up foreign reserves as a buffer against the risk of capital inflows, although the likelihood of this happening is small. Additionally, reserves are needed as a buffer against domestic liquidity shocks, as the U.S Dollar is the major currency used for domestic transactions.

C.4 Enhancing Data Adequacy

42. **The authorities have made progress in improving official statistics**. Monthly budget implementation numbers have been released regularly and in a timely manner. The Public Debt Statistical Bulletin (PDSB) provides a detailed overview of the current structure of public debt. Additionally, economic and monetary statistics have been regularly published by the NBC. Monthly reports on economic and monetary statistics have also been issued on a timely basis. Separately, quarterly BOP data has been gradually improved by leveraging on more data sources.

43. **Further improvement in data adequacy is needed to enhance economic assessment**. Detailed GDP statistics still lack the required frequency. Separately, the coverage of CPI inflation data is still limited to Phnom Penh area, while a PPI index is yet to be constructed. Regarding the fiscal sector, the PDSB could include estimates of contingent liabilities from government guarantees for various infrastructure projects. In the area of real estate, data related to the implementation of construction projects, as well as a regular survey of the real estate sector with broader coverage, will help analysts assess conditions and risks in the sector more accurately.

D. Appendices

Table 1. Major Economic Indicators and Projections

	2014	2015	2016	2017 Proj.	2018 Proj.
National income and prices	(Annual percentage change unless otherwise specified)				
Real GDP	7.1	7.0	7.0	6.9	6.8
Consumption (in percent of GDP)	83.0	82.2	82.1	83.6	84.2
Investment (in percent of GDP)	22.1	22.5	23.3	23.1	23.0
Savings (in percent of GDP)	14.8	16.4	16.3	15.4	14.9
GDP deflator	2.6	1.7	3.2	1.4	1.7
Consumer price inflation (average)	3.9	1.2	3.0	3.3	3.5
Consumer price inflation (end of period)	1.1	2.8	3.9	2.7	4.3
Balance of payments	(In millions of U.S. dollars unless otherwise specified)				
Trade balance	-3205.9	-3467.3	-3416.0	-3811.4	-4056.1
Current account balance	-1640.3	-1693.1	-1781.5	-1828.6	-1955.7
In percent of GDP	-9.8	-9.4	-8.9	-8.4	-8.3
Overall balance	754.4	775.0	846.5	773.7	545.5
Gross international reserves 1/	4391.0	5093.0	6730.0	8653.7	9349.2
In months of imports of goods & services	4.2	4.4	5.5	6.7	6.9
Coverage of short-term debt by remaining maturity (%)	86.2	88.8	104.6	124.8	128.1
External Debt	11270.2	11696.8	12804.6	13771.1	14736.9
In percent of GDP	67.5	64.7	63.9	63.2	62.4
General government	(In percent of GDP)				
Revenue and grants	20.1	18.5	19.2	20.5	20.6
Revenue	16.9	17.8	18.4	19.9	20.0
of which: tax revenue	14.4	15.4	15.9	17.4	17.5
Expenditure	21.2	20.4	21.8	23.5	23.8
Expense	12.8	13.0	14.5	15.7	16.2
Net acquisition of non-financial assets	8.4	7.4	7.3	7.8	7.5
Overall budget balance, excl. grants	-4.3	-2.6	-3.4	-3.6	-3.7
Net lending/borrowing balance	-1.1	-1.9	-2.6	-3.0	-3.2
Primary net lending/borrowing balance	-0.8	-1.6	-2.2	-2.7	-2.9
Monetary sector	(Annual percentage change unless otherwise specified)				
Domestic credit	28.5	24.3	21.9	16.9	17.4
Private sector	31.3	27.1	22.5	13.2	13.6
Broad money	29.9	14.7	17.9	15.3	16.6
Reserve money	24.6	21.7	25.0	26.3	22.7
Memorandum items:					
Nominal GDP (in billions of riels)	67436.8	73422.7	81242.0	88077.5	95690.2
(In millions of USD)	16700.5	18077.7	20035.0	21782.5	23627.2
GDP per capita (USD)	1094.6	1158.7	1265.9	1354.9	1447.4
Exchange rate (Riels per USD, average)	4038.0	4060.0	4055.0	4043.5	4050.0
Exchange rate (Riels per USD, end of period)	4075.0	4050.0	4037.0	4050.0	4050.0

Notes: 1/ Reflects RMB inclusion in SDR basket from 1 October 2016
Source: Cambodia authorities, World Bank, AMRO staff projections; 2017 figures are based on AMRO projections

Table 2. Balance of Payments

	2014	2015	2016	2017 Proj.	2018 Proj.
		(In millions of US dollars)			
Current account	**-1,640**	**-1,693**	**-1,782**	**-1,829**	**-1,956**
Trade balance	-3,206	-3,467	-3,416	-3,811	-4,056
Exports, f.o.b.	7,407	8,453	9,233	9,556	9,994
Imports, f.o.b.	10,613	11,920	12,649	13,367	14,050
Services, net	1,928	2,033	1,975	2,199	2,309
Primary income, net	-955	-1,107	-1,252	-1,215	-1,343
Secondary income, net	593	848	911	999	1,134
of which: official transfer	325	349	386	368	377
Capital and financial account	**2,440**	**2,565**	**2,607**	**2,602**	**2,501**
Capital account	278	172	160	150	150
Financial account (net)	2,163	2,393	2,447	2,452	2,351
Direct investment	1,677	1,654	2,166	2,384	2,383
Portfolio investment	-23	-15	-2	2	2
Medium- and long-term loans	478	514	430	467	466
Disbursements	554	588	544	600	599
Amortization	76	74	114	134	133
Other investment	30	241	-147	-400	-500
Errors and omissions	**-46**	**-97**	**21**	**0**	**0**
Overall balance	**754**	**775**	**846**	**774**	**546**
Financing	**-754**	**-775**	**-846**	**-774**	**-546**
Memorandum items:					
Exports of goods and services	*11,218*	*12,405*	*13,271*	*13,862*	*14,551*
Imports of goods and services	*12,496*	*13,837*	*14,610*	*15,474*	*16,298*
Trade account (% GDP)	*-19.2*	*-19.2*	*-17.1*	*-17.5*	*-17.2*
Current account (% GDP)	*-9.8*	*-9.4*	*-8.9*	*-8.4*	*-8.3*
Capital and financial account	*14.6*	*14.2*	*13.0*	*11.9*	*10.6*
Overall Balance	*4.5*	*4.3*	*4.2*	*3.6*	*2.3*
International reserves (In millions of USD) 1/	*4,391*	*5,093*	*6,730*	*8,654*	*9,349*
In months of imports of goods and services	*4.2*	*4.4*	*5.5*	*6.7*	*6.9*
GDP (In millions of USD)	*16,701*	*18,078*	*20,035*	*21,782*	*23,627*

Notes: 1/ Reported by NBC and reflects RMB inclusion in the SDR basket from 1 October 2016
Source: MEF, NBC, AMRO staff projections

Table 3. Monetary Survey

	2014	2015	2016	2017 Proj.	2018 Proj.
			(In billions of riels)		
Monetary Survey					
Assets					
Net foreign assets	**26,742**	**26,707**	**31,814**	**30,343**	**32,552**
Assets	34,928	39,355	47,582	50,157	52,767
Liabilities	-8,186	-12,648	-15,767	-19,814	-20,214
Net domestic assets	**15,869**	**22,161**	**25,802**	**36,093**	**44,907**
Net domestic Credit	31,885	39,642	48,310	56,493	66,307
Government	-4,359	-6,429	-8,148	-7,395	-6,239
Private sector	36,245	46,071	56,459	63,888	72,546
Other items net	-16,016	-17,481	-22,508	-20,400	-21,400
Liabilities					
Broad money	42,612	48,868	57,617	66,436	77,459
Currency in circulation	5,645	5,942	6,473	7,792	7,793
Deposits	36,966	42,926	51,143	58,644	69,666
Net domestic credit	28.5	24.3	21.9	16.9	17.4
Private sector credit	31.3	27.1	22.5	13.2	13.6
Broad money	29.9	14.7	17.9	15.3	16.6
NBC reserve money	24.6	21.7	25.0	26.3	22.7
Contribution to yoy Growth of Broad Money					
Net foreign assets	16.6	-0.1	10.5	-2.6	3.3
Net domestic assets	13.3	14.8	7.5	17.9	13.3
Net domestic credit	21.6	18.2	17.7	14.2	14.8
Private sector	26.3	23.1	21.3	12.9	13.0
Other items net	-8.3	-3.4	-10.3	3.7	-1.5
Memorandum items:					
NBC NFA (in millions of USD)	*6,006*	*6,781*	*7,628*	*8,402*	*8,947*
(Changes in millions of USD)	*1,116*	*775*	*846*	*774*	*546*
Monetary survey NFA (in millions of US$)	*6,563*	*6,083*	*6,718*	*7,492*	*8,038*
Velocity (GDP-to-average broad money)	*1.79*	*1.61*	*1.53*	*1.42*	*1.33*
Money multiplier	*2.30*	*2.17*	*2.32*	*2.32*	*2.32*
Currency-to-deposits (%)	*15.3*	*13.8*	*12.7*	*13.3*	*11.2*
Broad money-to-GDP (%)	*63.2*	*66.6*	*70.9*	*75.4*	*80.9*

Source: MEF, NBC, AMRO staff projections

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Table 4. General Government Operations

	2014	2015	2016	2017 Proj.	2018 Proj.
			(In billions of riels)		
Revenue and grants (1)	**13,526**	**13,575**	**15,558**	**18,059**	**19,684**
Revenue, excl. grants	11,365	13,083	14,975	17,559	19,184
Tax revenue	9,690	11,303	12,952	15,315	16,710
Other revenue	1,675	1,780	2,023	2,244	2,475
Grants	2,161	492	583	500	500
Expenditure (2)	**14,286**	**14,998**	**17,711**	**20,699**	**22,727**
Expense	8,617	9,543	11,762	13,799	15,527
Compensation of employees	3,945	4,731	5,977	7,134	8,337
Net acquisition of non-financial assets	5,670	5,455	5,949	6,900	7,200
Net lending/borrowing = (1) - (2)	**-760**	**-1,423**	**-2,153**	**-2,640**	**-3,042**
Financing	760	1,423	2,153	2,640	3,042
Domestic (net)	-1,168	-663	407	754	1,156
Foreign (net)	1,928	2,086	1,746	1,887	1,887
Disbursement	2,238	2,386	2,206	2,427	2,427
Amortization	-310	-300	-460	-540	-540
			(In percent of GDP)		
Revenue and grants	20.1	18.5	19.2	20.5	20.6
Revenue, excl. grants	16.9	17.8	18.4	19.9	20.0
Of which: tax	14.4	15.4	15.9	17.4	17.5
Expenditure	21.2	20.4	21.8	23.5	23.8
Expense	12.8	13.0	14.5	15.7	16.2
Net acquisition of non-financial assets	8.4	7.4	7.3	7.8	7.5
Net lending/borrowing balance	-1.1	-1.9	-2.6	-3.0	-3.2
Primary net lending/borrowing balance	-0.8	-1.6	-2.2	-2.7	-2.9
Memorandum items:					
Primary net lending (in billions of Riels)	*-530*	*-1,203*	*-1,818*	*-2,374*	*-2,783*
Public debt (In millions of USD)	*5,284*	*5,648*	*6,078*	*6,544*	*7,010*
as of GDP	*31.58*	*31.24*	*30.34*	*30.04*	*29.67*
Interest payment as of GDP	*0.34*	*0.30*	*0.41*	*0.30*	*0.27*
Nominal GDP (in billions of Riels)	*67,437*	*73,423*	*81,242*	*88,077*	*95,690*

Source: MEF, AMRO staff projections

Table 5. Data Adequacy for Surveillance Purposes: A Preliminary Assessment

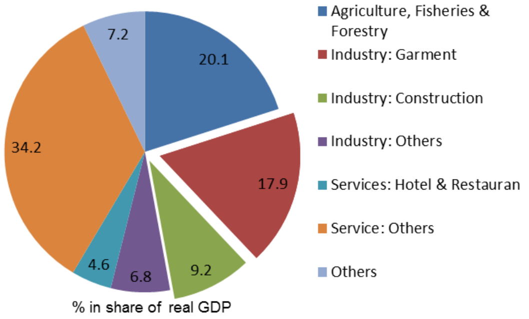
Criteria/ Key Indicators for Surveillance	Availability(i)	Reporting Frequency/ Timeliness(ii)	Data Quality(iii)	Consistency(iv)	Others, if any(v)
National Accounts	- GDP on the production side is the main approach used while details relating to the expenditure approach are yet to be made available - Unemployment and labor market data are yet to be made available	Dissemination of GDP data is on an annual basis with a time lag of three to seven months.	National Accounts statistics are compiled broadly in accordance with SNA93 standards. Data collection techniques remain weak due to resource constraints.	Revisions are frequent but becoming less significant. Officially, the statistical discrepancy is around 3.0 percent or less of GDP in constant prices	-
Balance of Payments (BOP) and External Position	- BOP data are published on the NBC website - Import and export data are published by the MEF - External trade data breakdown by category, destinations and origins are not yet available - Time-series detailed data on external debt and international reserves are not yet available	- BOP data is released on a yearly and quarterly basis with a time lag of one to three quarters - Trade data has been released on a monthly basis with a time lag of one to five months	- The BOP is published broadly in conformity with the BPM5 but some coverage limitations exist - Import data published by MEF are incomplete, as it covers only the major items.	Trade data are often inconsistent among government agencies	- Improving the compilation of trade and external debt data and the FDI survey is still work-in-progress. - A timely (schedule-based) release of comprehensive external sector statistics would strengthen economic analysis and monitoring
State Budget and Government/ External Debt	- Budget implementation data are released on the MEF website - Contingent government liability statistics are not yet available	Budget implementation statistics are published on a monthly basis with a time lag of one to three months	The data coverage is limited to the budget and is not fully integrated with activities related to the disbursement of external loans and grants	The bridge between the government's accounts and the GSFM 2001 classification has been studied by MEF in order to use accounting records as a source data in compiling GFS	Reforms based on the GFSM 2001 have been gradually implemented
Money Supply and Credit Growth	- CPI data for Phnom Penh are published by the NIS - National CPI data have yet to be made available - Monetary statistics have been released on the NBC website - Data on credit breakdown into sectors are also available	- CPI data are released on a monthly basis with a time lag of one to three months - Monetary and credit data are published on a monthly, quarterly and yearly basis with a time lag of three to six months	- The compilation of the CPI suffers from insufficient coverage - The actual amount of dollars and other foreign currency-denominated bills circulating in the economy has not been captured in the official monetary statistics	-	- Regular and timely (schedule-based) publication of headline and core inflation would strengthen economic monitoring
Financial Sector Soundness Indicators	- Some annual indicators are published by the NBC - Foreign assets and liabilities for the banking sector in aggregate are published by the NBC - A regular and detailed breakdown of the composition of foreign assets and liabilities of the banking sector is not yet available	Yearly data are released on the NBC website with a time lag of three to six months	Indicators are generally based on reports from banks and microfinance institutions - In addition to banking indicators, data on microfinance activities are lacking	-	- The availability of more comprehensive and more frequent data, including the detailed breakdown of assets and liabilities, would help in the analysis of financial sector soundness as a whole

Notes:
(i) Data availability refers to whether the official data are available for public access by any means.
(ii) Reporting frequency refers to the periodicity that the available data are published. Timeliness refers to how up-to-date the published data are relative to the publication date.
(iii) Data quality refers to the accuracy and reliability of the available data given that the data methodologies are taken into account.
(iv) Consistency refers to both the internal consistency within the data series itself and its horizontal consistency with other data series of either same or different categories.
Other criteria may also apply, if relevant. Examples include, but are not limited to, potential areas of improvement for data adequacy.

Source: AMRO staff calculations. This preliminary assessment will form the "Supplementary Data Adequacy Assessment" in the EPRD Matrix

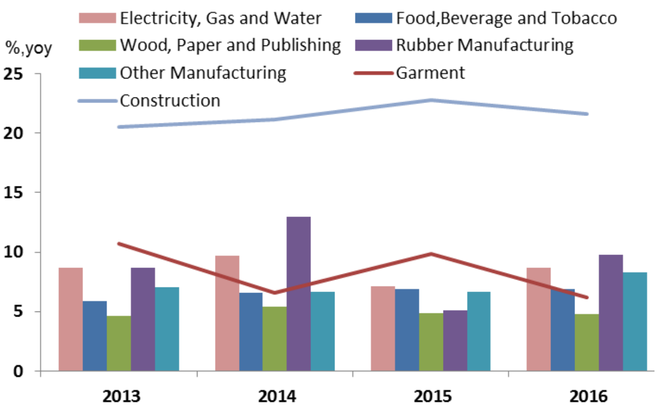
Figure 1. Economic Growth and the Real Sector

The garment sector accounts for a substantial share of the real GDP.



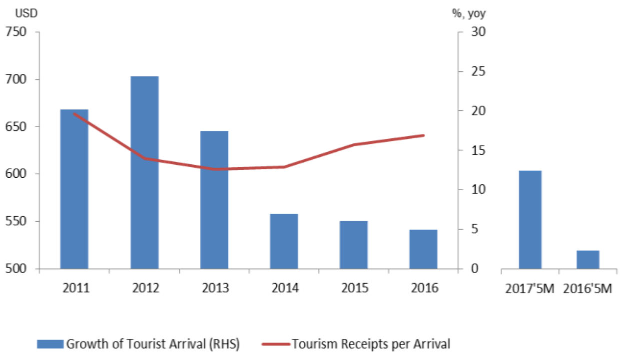
Note:
Source: National Institute of Statistics (NIS)

The growth of the garment sector has been slowing, but it has been partially offset by faster growth in other sectors.



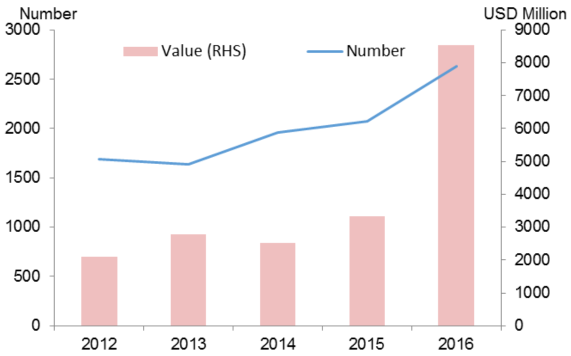
Note: Garments and Construction are sub-categories in the Industry category.
Source: NIS

With tourism receipts starting to pick up mildly, tourist arrival growth rebounded in 2017.



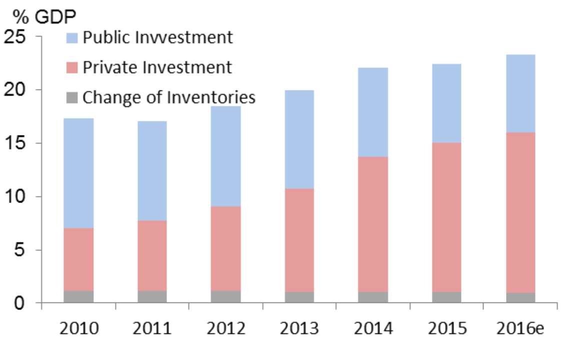
Source: Ministry of Tourism

Approvals for construction projects continued to remain strong.



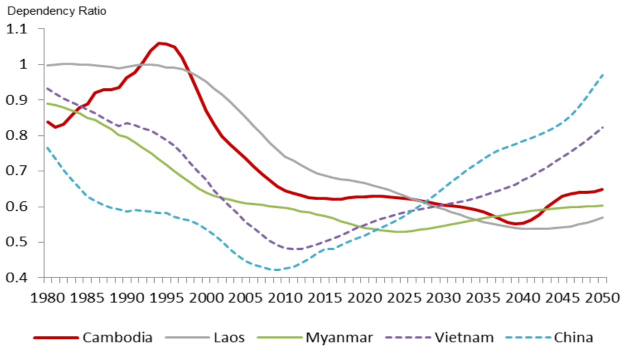
Source: Ministry of Land and Urban Planning

Private investment picked up and contributed more to capital formation.



Source: NIS, AMRO staff estimates

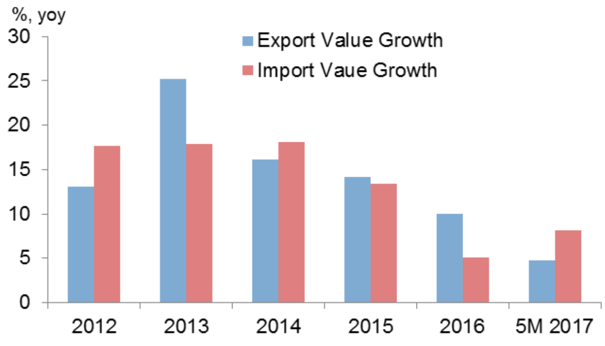
The demographic structure will continue to favor Cambodia with the continuation of the low dependency ratio.



Notes: Dependency ratio is the ratio of the population aged between 0 to 14 and that over the age of 60, over the population aged 15 to 59.
Source: World Population Prospects, the United Nations (The 2015 Revision)

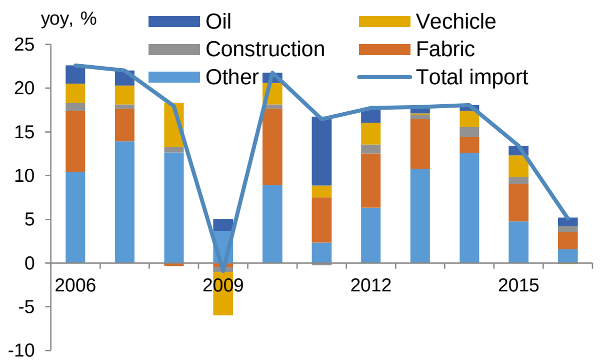
Figure 2. External Sector

Both export and import value growth rates have been decelerating.



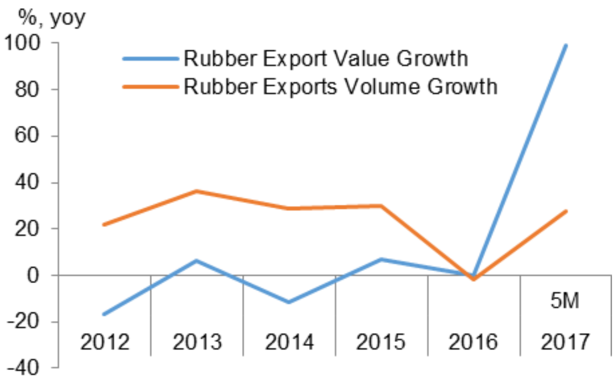
Note: Growth contribution in terms of exports value.
Source: MEF, AMRO staff calculations

Imports growth for items related both to re-exports and to domestic consumption slowdown.



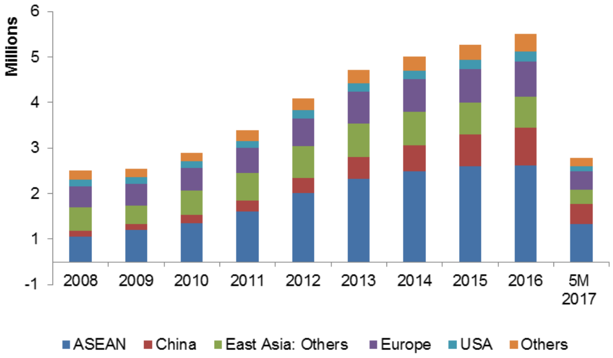
Notes: Growth contribution in terms of imports value, including tax-exempt imports
Source: MEF, AMRO staff calculations

The rebound of rubber prices helped export more in 2017.



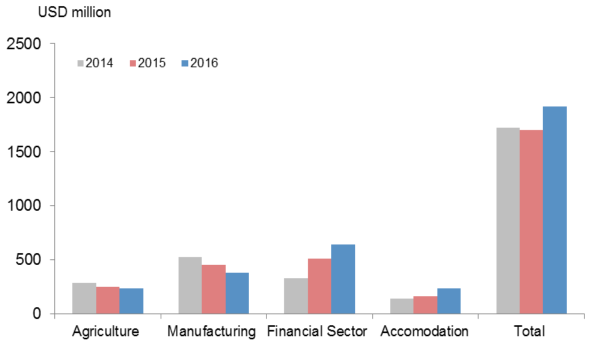
Source: MEF, AMRO staff calculations

There is a strong rebound of tourist arrivals growth in 2017.



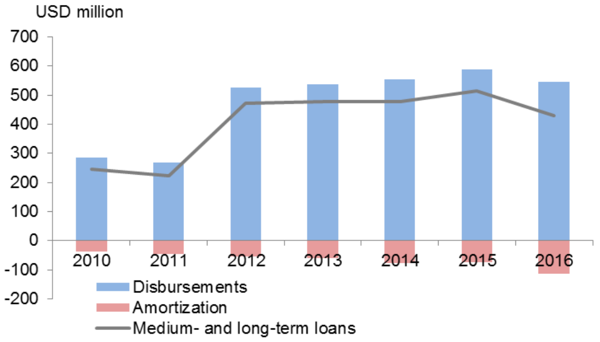
Source: Ministry of Tourism

FDI increased in 2016 driven by the inflows to the financial sector and hotel business.



Source: NBC

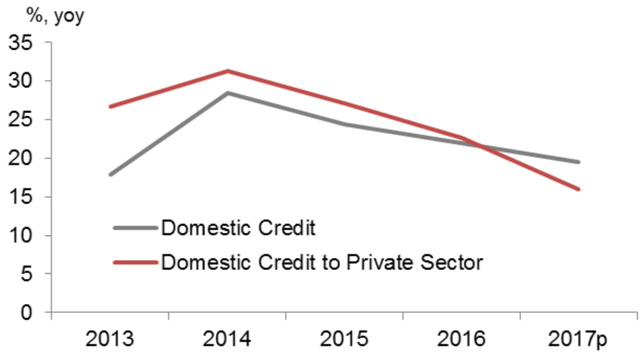
The Inflows related to Government Borrowings were relatively flat.



Source: NBC

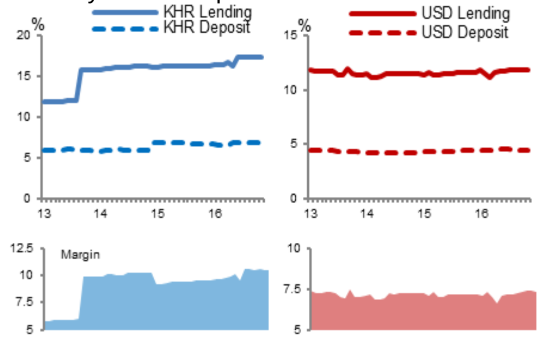
Figure 3. Monetary and Financial Sectors

Domestic credit growth to the private sector softened.



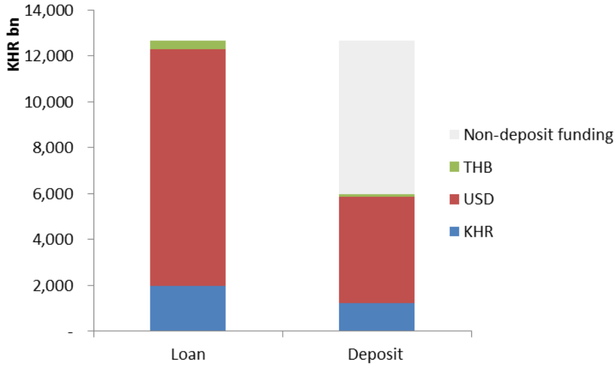
Source: NBC

Commercial banks' interest rates remained relatively stable despite U.S. interest rate hikes.



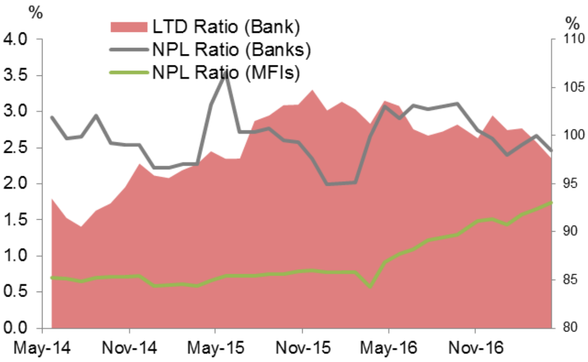
Source: Bloomberg

The USD still dominates the loans and deposits portfolio of MFIs, and external funding is the main source.



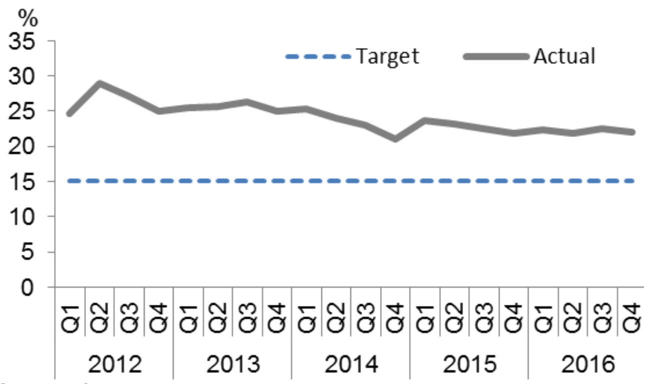
Note: 2016 data.
Source: NBC

While the loan-to-deposit ratio stabilized in tandem with slower credit growth, the NPL ratio edged up, especially for MFIs



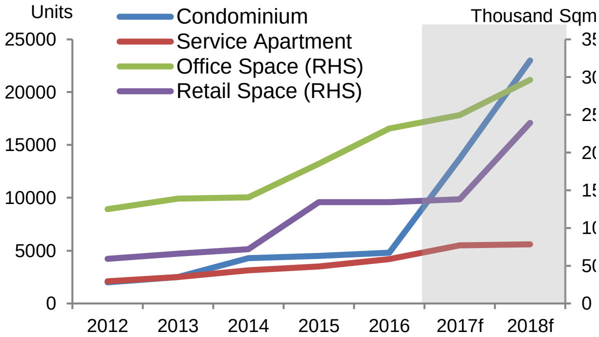
Source: NBC

Capital adequacy ratio continued to be above the required level.



Source: NBC

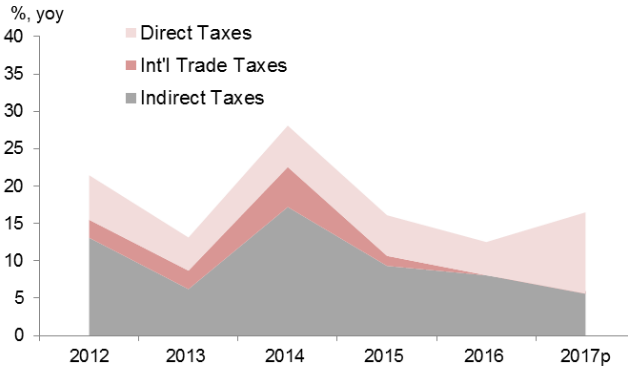
With a sharp increase in the supply of condominium units and tougher competition, more projects are likely to switch from the luxury to the middle-range segment.



Source: Knight Frank

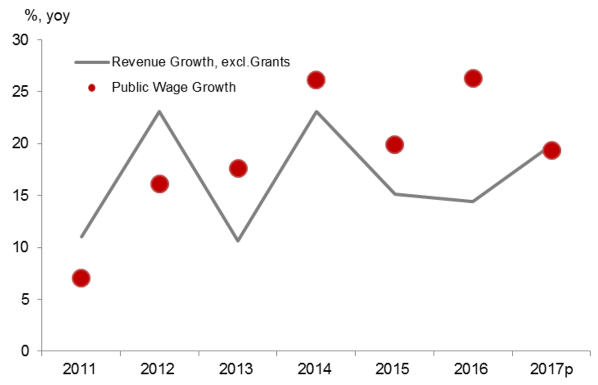
Figure 4. Fiscal Sector

Revenue collection, particularly tax revenue, outperformed the budget again in 2016.



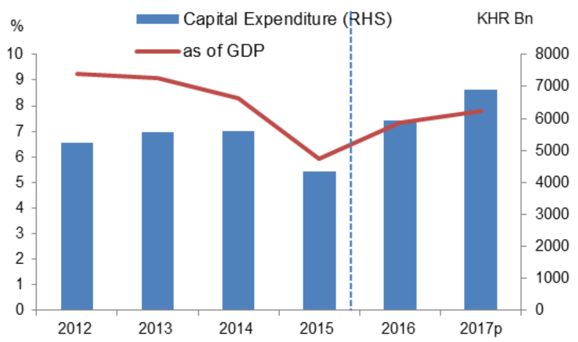
Note: On a fiscal year basis for all charts in Figure 3
Source: MEF

Public wage growth has outpaced revenue growth over time, and it has also increased its share of total expenditure.



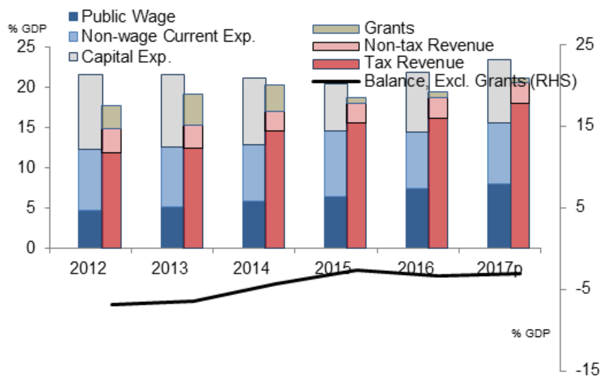
Source: MEF

Capital expenditure has started picking up since 2016.



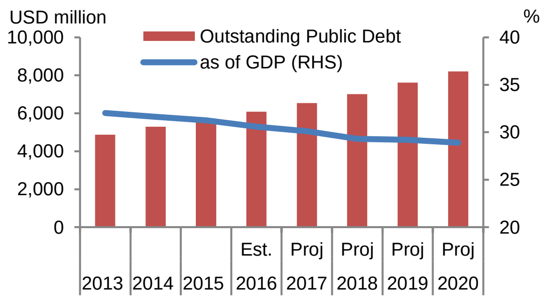
Source: MEF

Continued revenue growth has narrowed the fiscal deficit over time and improved the fiscal space.



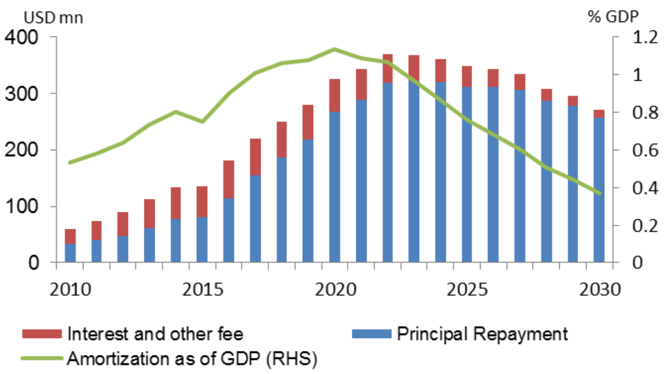
Source: MEF

While outstanding public debt will increase in value, its ratio to GDP will decline going forward.



Source: MEF

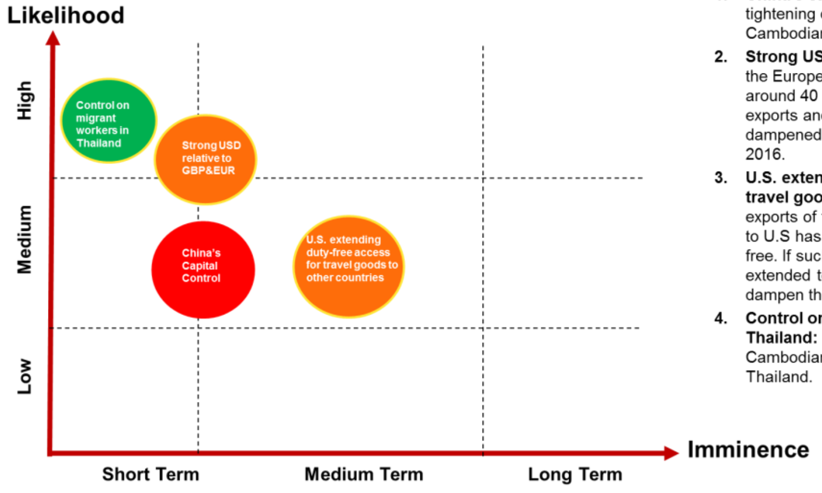
Debt service for the existing debt stock is picking up in value, but remains small as a percentage of GDP.



Source: MEF

Figure 5. Risks and Vulnerabilities

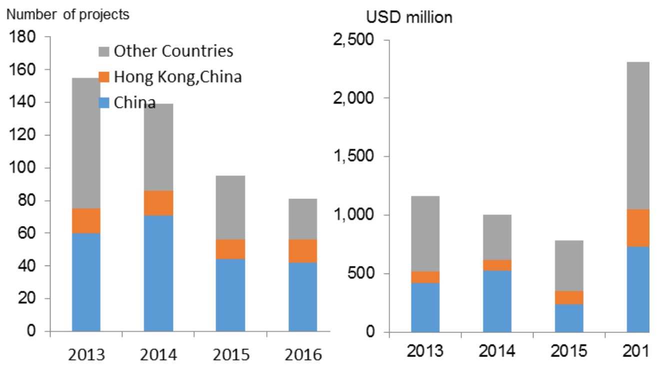
Risk Map: Cambodia



1. **China's capital control**: China's tightening on ODI could affect Cambodian FDI inflows.
2. **Strong USD relative to GBP & EUR:** the European market accounted for around 40 percent of Cambodian exports and Cambodia exports were dampened due to GBP depreciation in 2016.
3. **U.S. extending duty-free access for travel goods to other countries:** the exports of travel goods from Cambodia to U.S has been growing fast with duty-free. If such duty-free access is extended to other countries, it will dampen the prospect.
4. **Control on migrant workers in Thailand:** There is more than 1 million Cambodian migrant workers in Thailand.

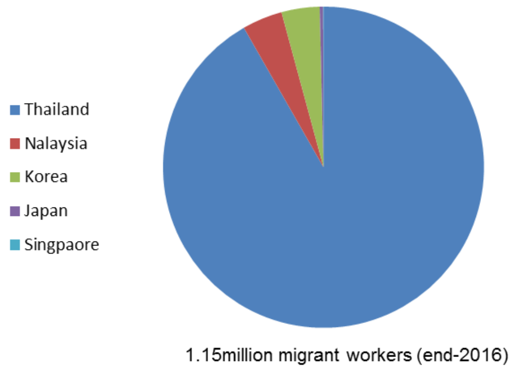
Source: AMRO

China accounts for a major share of approved FDI investment projects.



Source: MEF

Thailand hosts a majority of Cambodian overseas migrant workers.



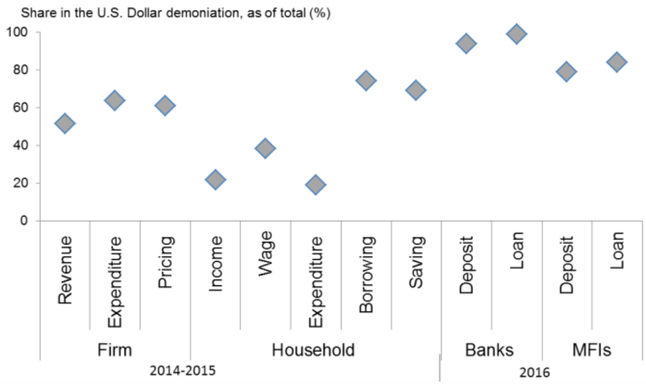
Source: Ministry of Labor and Vocational Training

Selected Issue: Dollarization, Inflation and Exchange-rate Based Monetary Policy[28]

44. **Cambodia is substantially dollarized in the real sector.** According to the 2014-2015 economic survey by JICA and the NBC, 51.7 percent of firms' revenues and 63.8 percent of their expenditures were in the form of foreign currencies (predominantly the U.S. dollar). In terms of firms' pricing behavior, 60.0 percent of firms quoted their prices in foreign currencies. Separately, 21.6 percent of households' incomes and 19.1 percent of expenditures were not reported in the local currency KHR. Households' borrowings and savings—compared to revenue and expenditure—are more likely to be in the U.S. Dollar and about 70.0 percent of their total borrowings and savings are in foreign currencies.

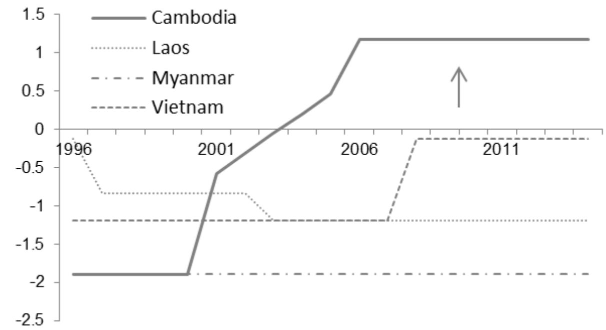
45. **The dollarization in the financial sector is higher than in the real sector.** The U.S. Dollar deposits accounted for 94.0 percent of total deposits and 83.0 percent of broad money (M2) at end-2016. In keeping with the U.S. Dollar's dominance in deposits, and with few policy restrictions on lending currency requirements, lending is also mainly in the form of U.S. Dollar for both commercial banks and MFIs.[29]

Cambodia is highly dollarized across various measures…



Source: JICA, NBC, AMRO staff estimates

… and has a very open capital account as suggested by the Chinn-Ito index



Source: The Chinn-Ito index (KAOPEN)

46. **As the high degree of dollarization constrains the choice of policy tools, the NBC has chosen a monetary regime centered on maintaining the stability of the exchange rate.** The interest rates in the financial markets are largely not under the control of the NBC and are determined by the markets.[30] The capital account in Cambodia is highly open, allowing for easy capital movement across the border. According to the Chinn-Ito index, a de jure measure of capital account openness, Cambodia ranked first compared to its neighbors in terms of capital account openness, and second

[28] This selected issue is based on a working paper, "Inflation and Monetary Policy in a Highly Dollarized Economy", by Xianguo Huang (AMRO) and Channarith Meng (NBC).

[29] A new regulation, announced on 1 December 2016, requires KHR loans to account for at least 10.0 percent of the total loan portfolio. This requirement will be fully implemented by 31 December 2019.

[30] Given the absence of an interbank market, the policy channel through which the short-term interest rate can be used to fine-tune monetary conditions is yet to be developed. Meanwhile, even if the NBC can determine the KHR interest rate through interbank or policy rates, the effect on overall market interest rate will still be marginal until KHR accounts for a more significant share in financial system.

only to Singapore in ASEAN. Forgoing control of the market interest rates due to constraints of dollarization, the NBC's stated objective is to fine-tune inflation through a managed exchange rate. While aiming to maintain stable prices, there is no explicit inflation target set by the NBC. The bilateral rate between the USD and the KHR is managed through open-market operations.

47. **To examine the effect of exchange rate on inflation, a Bayesian time-varying model is constructed to examine the dynamics.** We examine the variables of interest in a Time-Varying-Parameter Vector-Autoregression (TVP-VAR) Model, which can be represented by the following:

$$\boldsymbol{Y_t = A_{0,t} + \sum_{i=1}^{l} A_{i,t} Y_{t-i} + e_t} \tag{1}$$

where Y_t is a vector of variables of interest, $A_{0,t}$ and $A_{i,t}$ are corresponding coefficient vectors and matrices of constant terms and lag variables. The volatility of e_t follows time-varying error covariance matrix Ω_t, which can be transformed through triangle reduction and Equation (1) can be rewritten as

$$\boldsymbol{Y_t = A_{0,t} + \sum_{i=1}^{l} A_{i,t} Y_{t-i} + C_t^{-1} H_t \varepsilon_t} \tag{2}$$

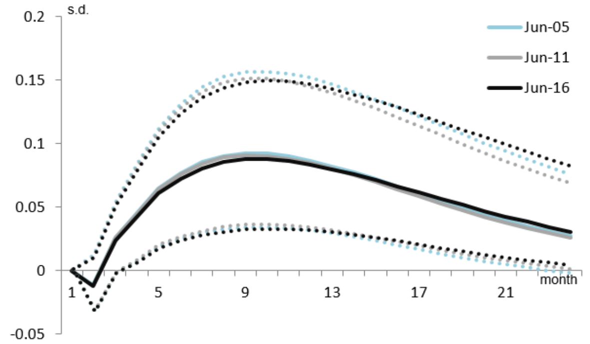
by capturing the correlations and heteroscedasticities through C_t^{-1} and H_t respectively as of Primiceri (2005), and Ω_t is equal to $C_t^{-1}H_t(C_t^{-1}H_t)'$. [31] In the baseline model, the variables include inflation, real output growth, money growth, and yoy changes of the NEER.

48. **Our empirical study suggests that the nominal exchange rate has a significant role to play in maintaining domestic price stability.** The impulse response of inflation to the shocks in NEER can be modeled in each period through simulation. For the purpose of demonstration, the simulations are conducted using the parameters from three points in time—June 2006, June 2011, and June 2016—were chosen to show the effects through impulse response. The impulse responses were relatively stable and persistent across the three time points, with the positive impacts lasting almost two years.[32] The impulse response suggests that one percentage point increase in NEER leads to a 0.11 percentage point increase in inflation after nine months. On the other hand, the impacts from money growth shock on inflation moderated and became less stable over time. Export volume growth, which is used to approximate real output growth, has an increasing effect on inflation over time but the effect is very small and not significantly different from zero.

[31] We follow the methodology specified in Cogley and Sargent (2005) and Primiceri (2005). Koop, Leon-Gonzalez, and Strachan (2012) extended a time-varying co-integration block into the model.

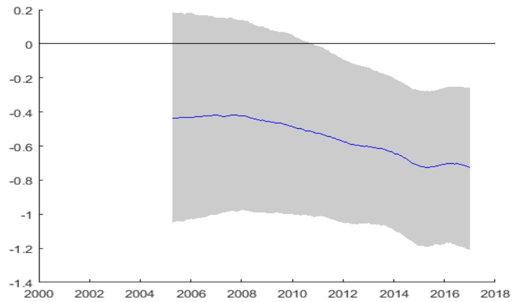
[32] The variables in the baseline model as specified include inflation, real output growth (approximated by clothing export volume), money growth, and yoy changes of the NEER constructed based on Cambodia's top 15 import partners. For the time-varying model, we use 20.0 percent of sample periods as training samples to form priors, and the remaining period to be examined starts from March 2005 taking lags as explanatory variables into consideration and ends in December 2016. The estimation of the model is based on the simulation of parameters' distribution through Gibbs sampling and Bayesian inference. A total of 50,000 iterations are conducted with 20,000 draws discarded to eliminate the serial correlation in the MCMC method.

Impulse responses of inflation to NEER shock across periods suggests FX plays an important and stable role in inflation dynamics



Note: The paths of the impulse response functions are constructed using posterior medians and the 16th and 84th percentiles of the simulated impulse response distribution at each point of time. Under normality, this interval corresponds to the bounds of a one-standard-deviation confidence interval.

With significant coefficients of dollarization (β_t^d) in recent years, policy rules could have been directed towards managing dollarization more instead of inflation



Note: Each point of the coefficient is constructed using the posterior median, and the band corresponds to the 16th and 84th percentiles. The result above is based on the change of KHR/USD relative to the change of broad dollar index. The pattern is similar if the choice of NEER but less significant and smaller. When it is the bilateral rate of KHR/USD, the coefficient is still in the negative region but less significant.

49. **However, the high degree of dollarization may constrain the use of this FX policy channel in price management.** We find no evidence that exchange rate policy has been actively used to manage inflation. Separately, we estimate the following hypothetical dual objective policy rule[33]

$$\boldsymbol{FX_t = \beta_{0,t} + \beta_t^p(p_t - p^*) + \beta_t^d d_t + e_t} \quad (3)$$

where $FX_t$is one type of exchange rate[34]; p_t and p^* are the inflation rate and targeted inflation rate respectively; and d_t refers to foreign-currency deposits as a percentage of M2 (a dollarization index). As shown in the chart, the time-varying coefficients of β_t^d becomes significantly different from zero only after 2010 (upper right figure). This suggests that the exchange rate would have decline (ie appreciate) in response to an increase in dollarization since 2010. However, according to the results, the response to inflation, β_t^d, is insignificant**.**

50. **Therefore, both the interest rate and exchange rate policy channels are highly constrained.** The use of the interest rate is highly constrained because of the high degree of dollarization as reflected in the dominance of the USD in the currency composition of both domestic financial assets and liabilities. The high degree of dollarization also implies that the bilateral exchange rate effective in affecting only the non-dollarized economy.

51. **Given the constraint on monetary policies, focusing on the role of prudential policies will be critical while continuing efforts to promote the use of KHR.** Given the constraints of monetary policy due to dollarization, building a comprehensive framework of macro and micro-

[33] This monetary rule assumes the central bank uses foreign exchange rate to affect inflation and the degree of dollarization.
[34] Three types of foreign exchange rate the KHR/USD rate, the NEER, and the KHR/USD rate relative to the broader dollar index (the differnce of changes of two rates) are examined respectively.

prudential policies with timely assessment and dynamic calibration, therefore, is critical for the NBC to play a more active role in macroeconomic management.