AMRO Country Report
ACR/21-07

AMRO Annual Consultation Report

Cambodia - 2021

ASEAN+3 Macroeconomic Research Office (AMRO)

November 2021

Acknowledgments

1. This Annual Consultation Report on Cambodia has been prepared in accordance with the functions of AMRO to monitor and assess the macroeconomic status and financial soundness of its members; identify relevant risks and vulnerabilities; report these to member authorities; and if requested, assist them in mitigating these risks through timely formulation of policy recommendations. This is being done in accordance with (Article 3 (a) and (b) of the AMRO Agreement).
2. This Report is drafted on the basis of the Annual Consultation Visit of AMRO to Cambodia from April 19 to May 4, 2021 (Article 5 (b) of the AMRO Agreement). The AMRO Mission team was headed by Dr Seung Hyun Luke Hong, Group Head and Lead Specialist. Members include Mr Paolo Hernando, Desk Economist on Cambodia; Dr Tanyasorn Ekapirak, Researcher; Ms Vanne Khut, Researcher; Ms Madeleine Vinuya, Research Data Analyst, Mr Sotheareach Sok, Associate and Mr Chea Yuthan, Associate. AMRO Director Mr Toshinori Doi and Chief Economist Dr Hoe Ee Khor also participated in key policy meetings with the authorities. This AMRO Annual Consultation Report on Cambodia for 2021 was peer reviewed by Dr Sumio Ishikawa, Group Head and Lead Economist, Dr Li Lian Ong, Group Head and Lead Specialist and Dr Jerry Huang, Economist, and approved by Dr Hoe Ee Khor, AMRO Chief Economist.
3. The analysis in this Report is based on information available up to 11 June 2021.
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 judgments 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

1. The economy was hit severely in 2020 by the COVID-19 pandemic and the recovery in 2021 is expected to be moderate and uneven across sectors. Despite very few COVID-19 cases and only light restrictions, the economy contracted by 3.1 percent in 2020, after growing by 7.0 percent on average in over the past 10 years. The fall in demand from major export markets and the restrictions on international travel had a severe impact on Cambodia's key growth drivers. Recovery from the pandemic is expected to gradually gain momentum in 2021, notwithstanding a recent spike in infections. Although the outbreak has reduced economic activity, Cambodia is projected to grow by 2.8 percent in 2021 led by a robust recovery in manufacturing, boosted by increased demand for garments and other manufactured exports as global demand rebounds.

2. Narrower current account deficit and higher international reserves strengthened the external position in 2020. In 2020, the current account deficit narrowed, as exports posted positive growth despite a contraction in garment exports. Meanwhile, imports fell across the board due to slower economic activities. Foreign direct investment (FDI) remained relatively stable and could fully offset the current account deficit, keeping the overall balance of payments in surplus. International reserves increased to USD 21.3 billion as of end-December 2020, equivalent to 11.1 months of imports of goods and services.

3. The fiscal deficit widened sharply in 2020 on account of lower revenues and the large stimulus package. The fiscal deficit widened significantly to 7.1 percent of GDP in 2020, as the contraction of the economy and the large fiscal support measures led to reduced revenue collection and increased budget outlays. The government has progressively rolled out fiscal stimulus measures to mitigate the impact of the pandemic, amounting to 6.6 percent of GDP for 2020 and 2021. Support measures are set to continue in the 2021 budget, with the fiscal deficit further increasing to 7.6 percent of GDP under conservative revenue assumptions.

4. Accommodative monetary measures helped provide ample liquidity to the system while credit growth moderated. To ensure sufficient liquidity in the financial system at the height of the pandemic, the National Bank of Cambodia (NBC) deployed various liquidity support measures including cutting interest rates and reducing the reserve requirement. Despite the increased liquidity, total credit growth remained subdued, as slower economic activity reduced loan demand and heightened uncertainties caused banks to remain cautious. Amid the challenging environment, the NBC's guidance for loan restructuring and regulatory forbearance measures helped financial institutions provide support to households and businesses affected by the pandemic.

5. Cambodia's economic recovery remains highly susceptible to the risk of resurgence in COVID-19 infections. The economy's high reliance on contact-intensive services sector and a labor-intensive manufacturing sector renders the economic recovery more vulnerable to sudden outbreak of infection given a relatively weak public health system. Extended lockdowns and uncontrolled resurgence of infections could result in severe damages to many service businesses as well as export companies.

6. Key external risks arise from uncertainties surrounding the evolution and impact of the ongoing pandemic. Given the importance of tourism in Cambodia's economy, the significant uncertainty over the resumption of international travel presents a key risk to the growth outlook for Cambodia. Prospects for the resumption of international travel remain bleak amid the resurgence in infections and slow vaccination in many countries, as well as the emergence of more infectious variants. Meanwhile, stronger than expected recovery in the U.S., E.U. and

U.K. markets could provide some upside opportunities for higher exports and growth for Cambodia.

7. Risks in the financial sector may stem from a deterioration in credit quality and asset price inflation. Given active loan restructuring by financial institutions, the differentiated recovery could lead to a further deterioration in credit quality. The difficulty in assessing the credit worthiness of restructured loans, combined with the possibility of inadequate provisioning ahead of an eventual unwinding of regulatory forbearance, could lead to a build-up of risks. The risk of asset price bubbles may also emerge once the economy recovers, particularly if the liquidity unleashed by the accommodative monetary stance goes to speculative investments in real estate.

8. Sizeable and sustained current account deficit may increase external vulnerability. As the import demand rebounds in 2021, current account deficit is forecast to widen sharply to 24.2 percent of GDP, the largest in two decades. Given the persistently high current account deficit, an adverse shock to foreign investment flows or sudden outflow from the banks' short-term deposits could quickly weaken the external position.

9. The pandemic may leave long-term scars on Cambodia's growth potential, impeding its quick return to sustainable high growth. Following a long period of high growth, the sudden economic contraction in 2020 poses considerable structural challenges to the economy. Factory and business closures have led to sizeable job losses. Unless idle resources and labor are properly redirected to sectors with growth potential, the economy's productive capacity will decline over time and result in permanent damage.

10. Given the slow and uneven recovery in an environment of high uncertainty, more targeted and flexible fiscal policy support is required. Amid this challenging environment, fiscal policy remains crucial, as the rollout of a broad fiscal stimulus package has played a vital role in supporting the economy. Going forward, fiscal support measures should become more flexible and targeted given the uneven recovery across sectors. As the economic recovery gains momentum, existing short-term crisis support measures should be carefully reviewed and recalibrated to focus more on bolstering economic recovery, while ensuring continued support for priority target groups. In sectors with prolonged economic distress, a review of program relevance and effectiveness should be conducted regularly so that adjustments can be made.

11. As demand for liquidity remains high, accommodative policy measures should continue while enhancing the monitoring and supervision of the financial system. As demand for liquidity remains elevated, accommodative policy measures should be maintained to ensure sufficient funding are available to productive sectors during the recovery. With the more accommodative financial conditions, the authorities should continue to closely monitor credit risk developments at banks, particularly those with thin capital buffers or high exposure to risky sectors.

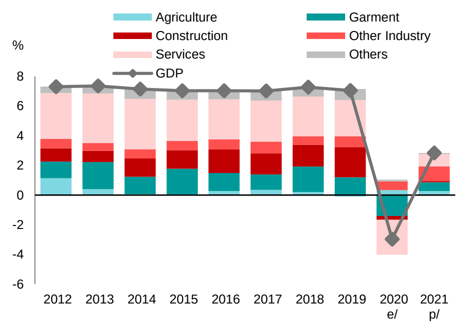
12. Coordinated efforts to address structural constraints should be accelerated to boost competitiveness and resilience of the economy. To enhance economic resilience, the authorities should continue efforts for diversification, including the development of domestic industries and attracting more FDIs into priority sectors. Addressing structural constraints in public infrastructure, skilled labor supply and institutional environment is critical in improving Cambodia's competitiveness. Working towards achieving Sustainable Development Goals (SDGs) such as social safety net as well as public health and education, would facilitate the implementation of structural reforms to ensure sustainable and resilient growth in the medium- and long-term.

A. Recent Developments and Outlook

A.1 Real Sector Developments and Outlook

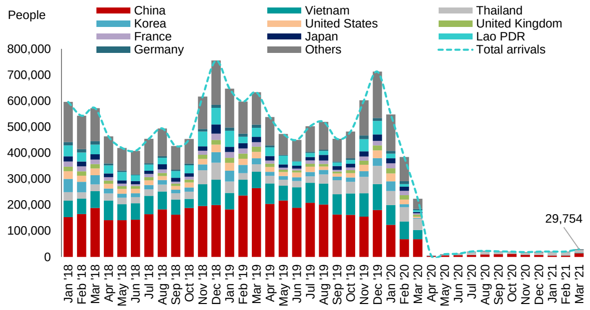
1. **The economy was hit severely in 2020 due to the COVID-19 pandemic.** Despite very few COVID-19 cases and only light restrictions, the economy contracted by 3.1 percent in 2020, after growing by 7.0 percent on average over the past 10 years. The fall in demand from major export markets and restrictions on international travel by many countries hit hard its key growth drivers – garment, tourism and construction. The biggest contraction was seen in the services sector, with the near-complete suspension in tourism-related operations since April 2020. The industry sector recorded a slight contraction, mainly driven by garment manufacturing, although recovering demand seen in H2 2020 partially offset the early damages in H1 2020 from supply chain disruptions and the subsequent collapse in demand. The agriculture sector managed to grow robustly, supported by higher demand for local products as substitutes for imports while exports of key agricultural products increased.

Figure 1. Contribution to Real GDP Growth



Source: National Institute of Statistics (NIS); AMRO staff calculations

Figure 2. International Tourist Arrivals



Source: Ministry of Tourism (MOT)

2. **Domestic demand shrank while the large fiscal expansion partly offset private sector contraction.** Private consumption contracted, as households' disposable income declined amid subdued economic activities, particularly in the high contact services sector and labor-intensive manufacturing sector. Job losses in tourism and garments resulted in a higher unemployment rate of 2.4 percent in 2020 from 0.1 percent in 2019.[1] Investments to the real estate sector contracted, especially in the high-end segment that relies mostly on foreign buyers. Meanwhile, net exports remained a drag on growth but was less negative in 2020 due to the contraction of imports. Amid these negative impacts, the government's large stimulus package helped mitigate the economic fallout from the pandemic.

3. **Recovery from the pandemic is expected to gradually gain momentum in 2021 notwithstanding a recent spike in infections, reflecting improved prospects of global trade.** Although the recent outbreak has reduced economic activity, Cambodia is still projected to grow by 2.8 percent in 2021 led by the robust recovery in manufacturing. Rebounding global demand is expected to boost the exports of garments and other manufactured products[2], but the recent COVID-19 outbreak and subsequent lockdowns will dampen the recovery momentum, as some factories and businesses were forced to temporarily close, particularly

[1] In addition, remittances declined as many migrant workers had to come back to Cambodia.
[2] Other major manufactured exports include electrical and vehicle parts, bicycles, insulated wires and optical cables.

those in designated red zones.[3] The agriculture sector is also expected to grow at a faster rate in 2021, benefiting from government support and favorable external conditions. Newly signed trade agreements, such as the China-Cambodia FTA and the Regional Comprehensive Economic Partnership (RCEP), are expected to attract additional foreign direct investment (FDI) and help increase Cambodia's exports to more markets. (Box A).

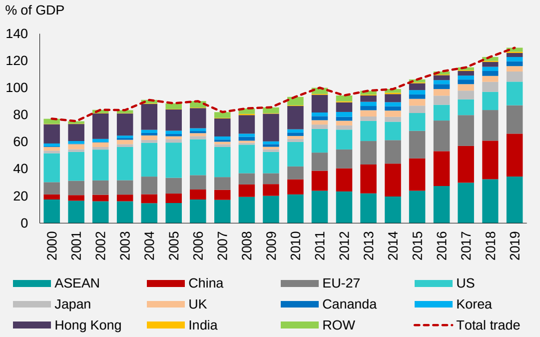
Box A. Cambodia's Recent Developments of Free Trade Agreements[4]

Having embraced an open market economy since 1993, Cambodia has witnessed remarkable progress in liberalizing its trade and investment, where free trade agreements (FTAs) and preferential trade agreements (PTAs) with major trading partners have played an important role. This box briefly reviews Cambodia's FTA developments.

The implementation of FTAs and PTAs has helped Cambodia to further open up its economy. Cambodia's total trade in goods reached roughly 130 percent of GDP in 2019, up from 77 percent in 2000 (Figure A1). Thus far, Cambodia has seventeen FTAs, of which seven are signed and in effect, and seven are still at the proposed/under consultation and study stages (Figures A2, A3). On top of the FTAs, Cambodia remains a beneficiary of the US's Generalized System of Preferences (GSP) and partially of EU's Everything But Arms (EBA).[5] [6]

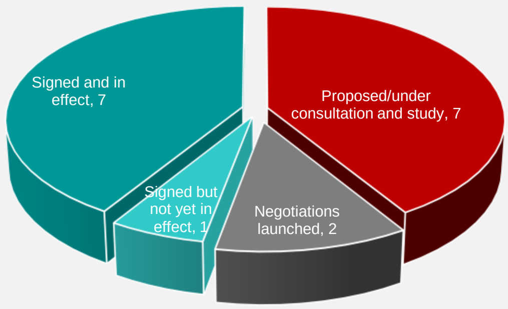
Despite the COVID-19 pandemic and uncertainties surrounding trade relations, the country continues its efforts to further expand FTA networks. After having successfully signed an FTA with China, Cambodia has recently concluded negotiations on an FTA with Korea[7], while considering expanding the networks with others, including India, Mongolia, and the Eurasian Economic Union, among others. The FTA with China is anticipated to help diversify Cambodia's export markets and products, cushioning the blow from the partial suspension of Cambodia's duty-free access to the EU market. Besides, the FTAs are also expected to further encourage FDI inflows and tourism in years to come.[8]

Figure A1. Cambodia: Top 10 Trading Partners



Note: Trade in goods is the sum of exports and imports of goods.
Source: World Bank's WITS; NIS; AMRO staff calculations

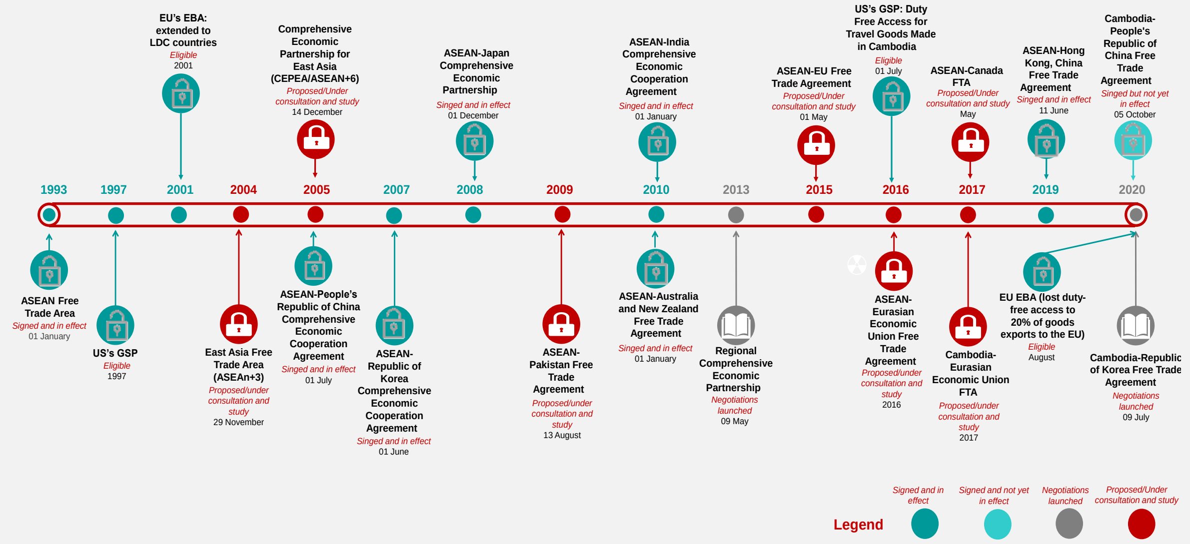
Figure A2. Cambodia: Number of Current Bilateral and Regional FTAs



Note: The data is as of October 2020.
Source: Asian Development Bank; Asia Regional Integration Center

[3] Areas under lockdown are categorized into red, orange and yellow zones. Red zones are areas experiencing the most stringent restrictions, with all businesses and factories closed, while residents are not allowed to go outside. Orange zones allow residents to go out for essential activities only, while yellow zones allow freer movement for residents, including the operation of businesses and factories as long as they comply with health and safety protocols.
[4] This box was prepared by Vanne Khut.
[5] Cambodia lost duty-free access to 20 percent of its goods exports to the EU in August 2020.
[6] For more details, see AMRO Annual Consultation Report Cambodia – 2018, Annex 3. Cambodia's Preferential Trade Schemes: Recent Developments and Risks
[7] Cambodia and Korea concluded their FTA negotiations on 3 February 2021.
[8] China has become the largest source of Cambodia's FDI inflows and tourists, accounting for 30.4 percent of total FDI inflows and 35.7 percent of total foreign visitors recorded in 2019, respectively.

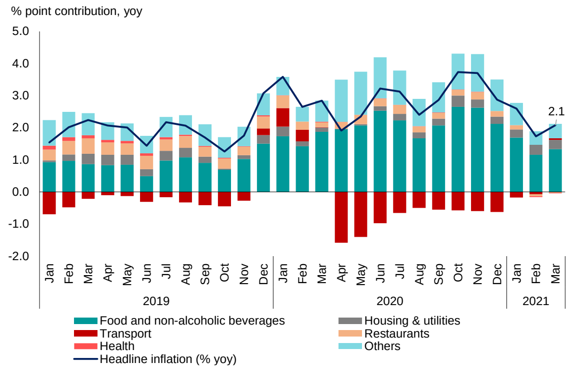
Figure A3. Cambodia: FTAs and PTAs, 1993 – 2020



Note: The information is as of October 2020.
Source: Asian Development Bank; Asia Regional Integration Center

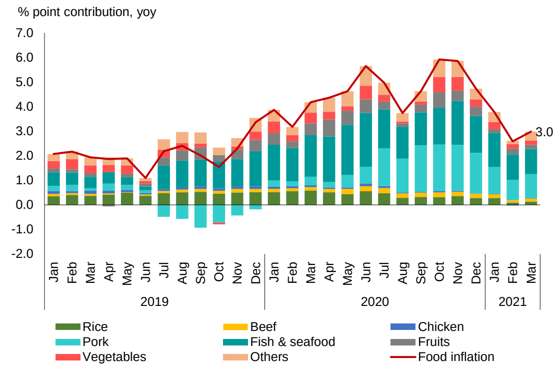
4. Inflation edged up in 2020 due to higher food prices. Inflation rose to 2.9 percent in 2020 from 1.9 percent in 2019, as higher food prices generally offset subdued transport prices. Prices of some key food items, especially pork, remained elevated in 2020, mainly due to occasional supply disruptions and large-scale flooding in the fourth quarter. Although food prices are expected to stabilize in 2021, temporary supply constraints during the lockdown and higher global oil prices would push up inflation to 3.3 percent in 2021.

Figure 3. Headline Inflation



Source: NIS; AMRO staff calculations

Figure 4. Food Inflation



Source: NIS; AMRO staff calculations

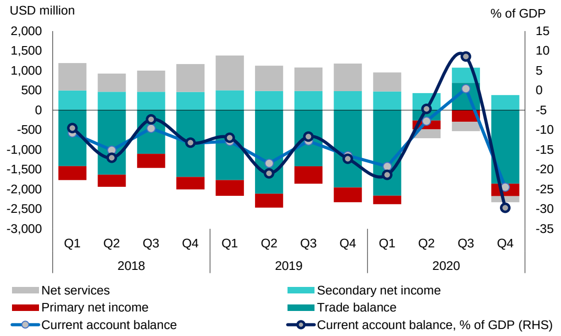
A.2 External Sector and the Balance of Payments

5. The current account deficit narrowed owing to a smaller trade deficit. The current account deficit narrowed to 11.5 percent of GDP in 2020 from 15.0 percent of GDP in 2019. Despite the 9.9 percent contraction in garment exports, total exports posted a growth of 16.7 percent mainly due to a one-time boost in gold exports.[9] Although coming from a low base, non-garment manufactured exports, particularly electrical and vehicle parts, bicycles, insulated wires and optical cables, expanded by 23.1 percent, providing additional support to export growth. As imports fell across the board due to subdued economic activity, the 2020 trade deficit narrowed to 13.5 percent of GDP from 26.8 percent in 2019. The services account

[9] Gold exports shot up to USD3.0 billion in 2020 from just around USD300 million in 2019.

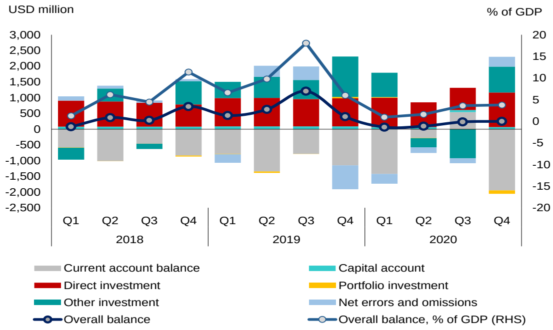
recorded a net deficit following the collapse in tourism, while remittances also declined by 17 percent.

Figure 5. Current Account Balance



Source: National Bank of Cambodia (NBC); AMRO staff calculations

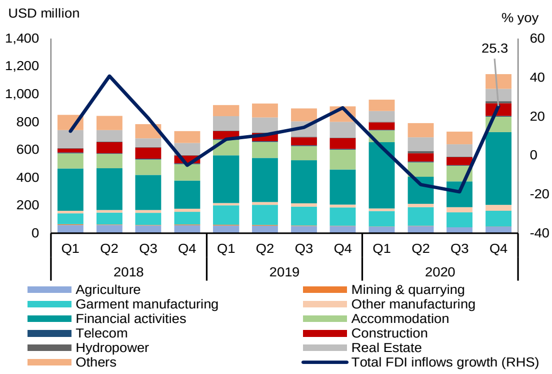
Figure 6. Balance of Payment



Source: NBC; AMRO staff calculations

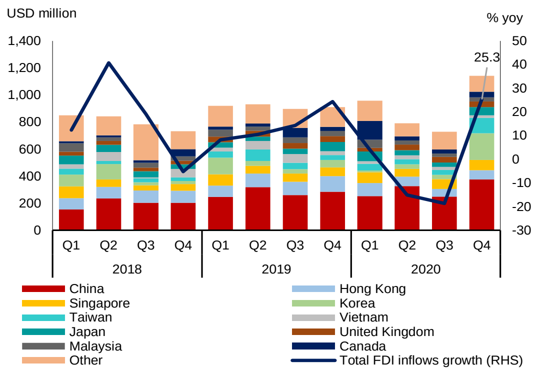
6. Steady inflows of foreign direct investment (FDI) have helped the overall balance of payments to remain in surplus. FDI inflows remained relatively stable, falling slightly by 1.8 percent in 2020, as the decline in real estate investments was offset by strong inflows to financial and industry sectors. The ASEAN+3 region continues to be Cambodia's main source of FDI, with China accounting for almost a third of inflows. Despite the slight fall in FDI, it could still fully offset the current account deficit, keeping the overall balance of payments in a surplus of USD 637 million. International reserves increased significantly to USD 21.3 billion as of end-December 2020, equivalent to 11.1 months of imports of goods and services.[10]

Figure 7. FDI Inflows by Sector



Source: NBC; AMRO staff calculations

Figure 8. FDI Inflows by Country



Source: NBC; AMRO staff calculations

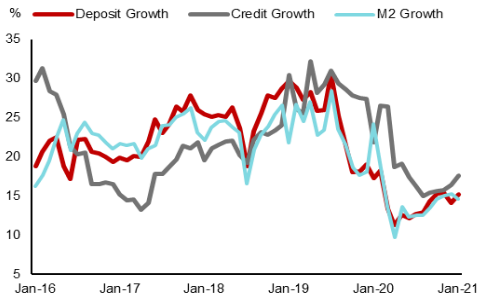
A.3 Monetary Condition and Financial Sector

7. Accommodative monetary measures helped provide ample liquidity to the system. To ensure sufficient liquidity in the financial system at the height of the pandemic, the National Bank of Cambodia (NBC) deployed various liquidity support measures including cutting interest rates for the Negotiable Certificate of Deposits (NCD) and Liquidity Providing

[10] The overall BOP surplus of USD 637 million is much lower than the USD 2.5 billion increase in international reserves, which is due mainly to revaluation gain and increased foreign currency deposits held by commercial banks at the central bank.

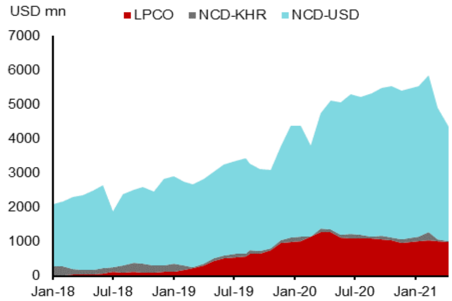
Collateral Operation (LPCO)[11], reducing the reserve requirements[12], and postponing the full implementation of the Capital Conservation Buffer.[13] These policy measures contributed to the gradual increase in Broad Money (M2) and deposits since April 2020. However, credit growth to the private sector remained relatively slow in H2 2020, after steadily declining since January 2020 (Figure 9). The ample liquidity can also be seen in banks' increased holdings of USD-denominated NCD, whose outstanding amount reached USD 4.3 billion by the end of 2020, increasing 59.1 percent from the end of 2019 (Figure 10).[14]

Figure 9. Credit, Deposit and M2 Growth



Source: NBC; AMRO staff calculations

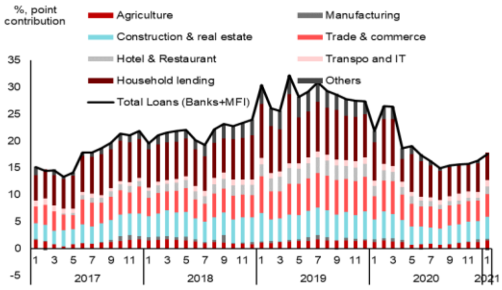
Figure 10. Outstanding NCD and LPCO



Source: NBC; AMRO staff calculations

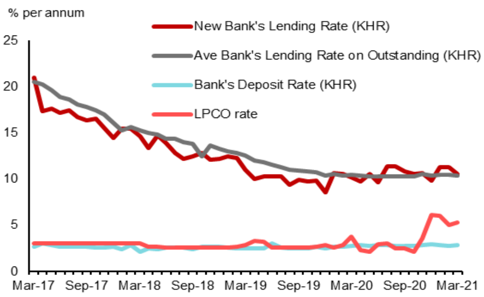
8. Credit growth moderated amid slower economic activity and heightened uncertainty. Growth in total loans—by both banks and MFIs—slowed from an average of 28.8 percent in 2019 to 15.8 percent in August 2020, before stabilizing at around 16 percent towards end 2020 (Figure 11). The slowdown in credit growth was due to lower lending to both households and firms, particularly business lending to trade and commerce, hotel and restaurant, and rental and leasing services. Although KHR lending rates have steadily declined in recent years, the slight increase seen in Q3 2020 and January 2021 may reflect higher risk premiums due to uncertainties brought about by the pandemic, as well as the increase in financing cost with the LPCO rate going up towards the end of 2020 (Figure 12).

Figure 11. Loan Growth (Bank and MFI)



Source: NBC; AMRO staff calculations

Figure 12. Bank Lending and Financing Rates



Source: NBC; AMRO staff calculations

[11] Interest rates were reduced for LPCO and NCDs, which are NBC's main tools to influence the liquidity of KHR and USD in the market, respectively. Interest rate for the 91-day LPCO declined from 4.0 percent in March 2020 to 2.6 percent in April 2020, which helped enhance the KHR liquidity in the market. Meanwhile, the interest rate for the 3-month NCD in USD declined to below 0.1 percent from May 2020 onwards.
[12] The reserve requirement ratio was reduced to 7 percent for both currencies from 8 percent for KHR and 12.5 percent for USD on March 18, 2020. According to the NBC's Semi-Annual Report 2020, the cut in the reserve requirement is estimated to have injected as much as USD1.8 billion liquidity into the financial system.
[13] The Capital Conservation Buffer introduced in 2019 was set at 50 percent of the BIS standard, and was scheduled to be raised in 2020 to fully comply with the international standard. However, due to the pandemic, the full implementation has been postponed.
[14] As of April 2021 outstanding USD-denominated NCD has fallen to USD 3.3 million as credit growth gradually picked-up, which is still 22 percent higher than the 2019 level.

Authorities' Views

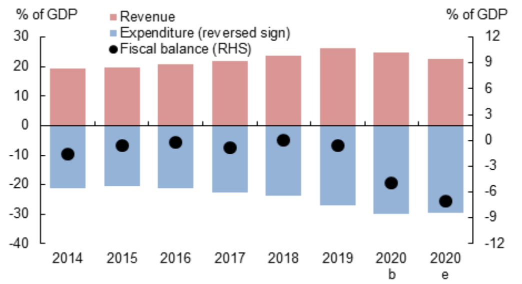
9. *The NBC notes the volatility of the LPCO rate during the pandemic. Although the LPCO is the main tool of the central bank to provide KHR liquidity in the market, it accounts for less than a fifth of total outstanding KHR loans. Thus, the volatility in the LPCO rate is not considered as the major factor in influencing the decline in credit growth but rather the dominant factor would be the higher risk premium from the uncertainties related to the pandemic.*

10. The NBC's guidance for loan restructuring and regulatory forbearance measures helped financial institutions provide support to households and businesses affected by the pandemic. Regulatory forbearance allows banks to provide loan restructuring without changing loan classification or provisioning requirements. Restructured loans peaked at USD4.4 billion in Sep 2020, and have steadily declined to USD3.8 billion as of March 2021, as more borrowers were able to resume business operations and service their debt. Non-performing loans (NPLs) have increased but remained relatively low at 2.2 percent for banks and 1.9 percent for MFIs as of March 2021, excluding restructured loans under the NBC's regulatory forbearance. Meanwhile, the capital adequacy ratio (CAR) stood at 23.6 percent as of end-March 2021, well above the regulatory minimum requirement of 15 percent. This provided a buffer against potential losses from a deterioration in the loan portfolio.

A.4 Fiscal Sector

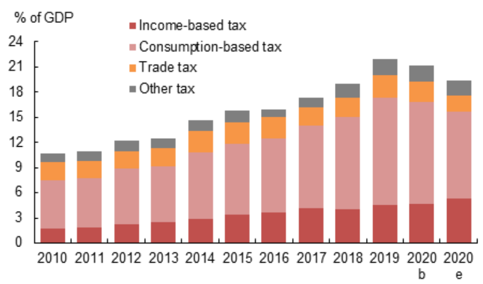
11. The fiscal deficit widened sharply in 2020 on account of lower revenues and the large stimulus package. The fiscal deficit is estimated to have widened significantly to 7.1 percent of GDP in 2020 from 0.6 percent in 2019 (Figure 13), as the contraction of the economy and the large fiscal support measures led to lower revenue collection and increased budget outlays. In light of the pandemic, the authorities had made a downward revision to the tax revenue target – to 80 percent of target in the original Budget Law. However, the authorities were still able to outperform the revised target with tax collection at 91.4 percent. (Figure 14).[15] Meanwhile, expenditure rose significantly to 29.6 percent of GDP in 2020, from 26.9 percent of GDP in 2019, as the government prioritized containing the pandemic and supporting the economy (Figure 16).

Figure 13. Fiscal Balance



Source: Ministry of Economy and Finance (MEF); AMRO staff calculations
Note: 2020b refers to the government budget; while 2020e refers to the government estimate.

Figure 14. Tax Revenues

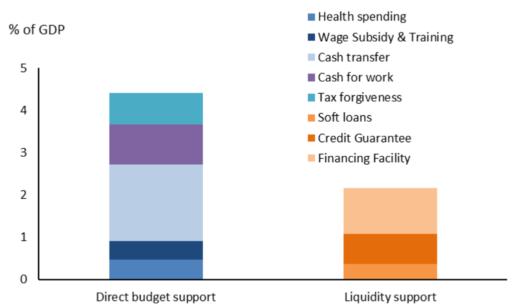


Source: MEF; AMRO staff calculations
Note: 2020b refers to the government budget; while 2020e refers to the government estimate.

[15] With the contraction of the economy and fiscal stimulus package, VAT and Excise taxes plunge by 13.5 percent and 29.3 percent in 2020, respectively. International trade taxes fell by 24.1 percent, and non-tax revenues also fell steeply by 40.5 percent. Only direct taxes were able to expand in 2020, growing by 14.2 percent.

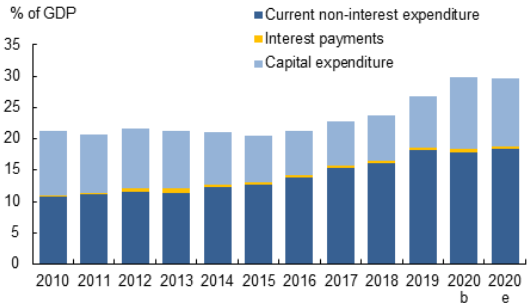
12. The Cambodian government has progressively rolled out fiscal stimulus measures to mitigate the impact of the pandemic. The fiscal stimulus package of USD1.82 billion (about 6.6 percent of GDP) encompasses various policy measures for 2020 and 2021. These included tax holidays for affected businesses,[16] wage subsidies to workers in garment factories and tourism companies, the expansion of small-scale public work projects, cash transfers to vulnerable households,[17] and financing facilities for SMEs (Figure 15).[18] The government plans to continue fiscal support programs in 2021 with a top-up of USD 449 million, while some programs are scheduled to expire by the end of June 2021. With the recent rise in community cases and lockdowns implemented in areas affected by the outbreak, the government has rolled out additional assistance to the vulnerable households living in those areas.[19]

Figure 15. 2020-2021 Fiscal Stimulus Package



Source: MEF; AMRO staff calculations

Figure 16. Expenditure by Components



Source: MEF; AMRO staff calculations
Note: 2020b refers to the government budget; while 2020e refers to the government estimate.

13. Public debt is expected to rise but will stabilize at below 40 percent of GDP in the medium-term, aided in part by the drawdown of fiscal reserves. Public debt is estimated to rise to 33.1 percent of GDP in 2020 from 28.1 percent in 2019, mainly due to the surging primary deficit and the contraction of real GDP growth. The increase in the public debt would have been higher by 1.6 percent of GDP if not for the drawdown of fiscal reserves of around USD422 million. An additional USD430 million is expected to be drawn from the reserves this year, helping to keep public debt low at 34.8 percent of GDP in 2021.[20] The planned increase in domestically financed public investment projects is projected to result in a further increase in public debt over the medium-term. However, the combination of fiscal consolidation and enhanced growth prospects is expected to gradually slow the pace of the debt increase, stabilizing public debt at around 38.2 percent of GDP by 2025.

[16] Tax holidays were initially provided to the garment sector suffering the disruptions in importing raw materials from China in February 2020. With COVID-19 cases started in March 2020, authorities boosted the fiscal response in terms of both magnitude and coverage, by expanding health spending and tax holidays, as well as supporting affected sectors such as tourism, logistics, and aviation.
[17] See Box C. Cash transfer program for poor and vulnerable households during COVID-19.
[18] See Box E. Government Policies for SME Development
[19] On 11 May 2021, the government announced two social assistance programs for the poor and vulnerable households in Phnom Penh, Kandal province's Takmao town and Preah Sihanouk province, by providing targeted cash assistance.
[20] This is in line with the government announcement at the onset of the pandemic that around USD 2 billion is planned to be drawn from fiscal reserves to help fund the fiscal stimulus package. With USD 680 million drawn in 2020 and around USD 430 million to be drawn in 2021, around USD 890 million could still be drawn from fiscal reserves to help fund the stimulus package.

B. Risks, Vulnerabilities and Challenges

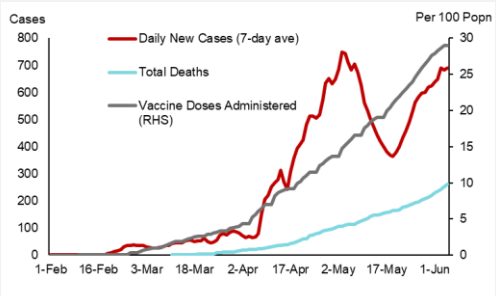
B.1 Near-term Risks to the Macro Outlook

14. Cambodia's economic recovery remains highly susceptible to the risk of resurgence in COVID-19 infections. Rising community cases since February 2021 and subsequent lockdowns in April to May underscore the sizeable pandemic-related downside risk to Cambodia's economy, highlighting the need to achieve widespread immunization (Box B). The economy's high reliance on contact-intensive services sector and a labor-intensive manufacturing sector renders the economic recovery more vulnerable to sudden outbreaks of infection given its relatively weak public health system. Extended lockdowns and uncontrolled resurgence of infections could result in severe damages to many service businesses as well as export companies, limiting their production capacities in receiving and delivering seasonal orders. This, in turn, will adversely affect the fiscal position and the medium-term consolidation plan. Ramping up vaccination will help reduce the need for strict containment measures to manage health risks.[21]

Box B. COVID-19 Outbreak in 2021[22]

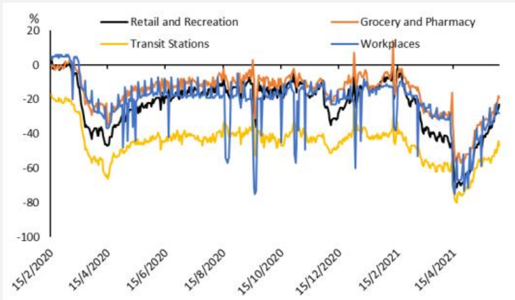
After successful containment in 2020, Cambodia has seen a sharp spike in COVID-19 cases in 2021. In 2020, COVID-19 infections in Cambodia were relatively well-contained, recording a total of 378 cumulative cases by the end of December 2020. However, this has changed since late February 2021, with a surge in new infections of the more infectious UK variant of COVID-19, known as B.1.1.7 (Figure B1). To help stem the spread of the virus, the government declared area lockdowns in Phnom Penh and some peripheral towns on 15 April, and the significant increase in diagnostic testing using Rapid Antigen Tests beginning April 19.

Figure B1. COVID-19 Daily Confirmed Cases and Vaccines Administered



Source: Haver Analytics; AMRO staff calculations

Figure B2. Google Mobility Tracker



Source: Google Mobility Report

The surge in new infections and subsequent lockdowns could put the recovery at risk. The impact of the current outbreak on the economy is expected to be directly felt in retail services and manufacturing. Mobility is severely restricted under the lockdown from 15 April to 6 May which fares worse compared to the lockdown in April 2020 (Figure 2). With 360 factories temporarily shut down (comprising around 40 percent of the total garment factories in Cambodia, affecting 300,000 workers), manufacturing could also be dampened substantially if factory shutdown persists. To minimize the economic fallout, the authorities announced a targeted lockdown on 27 April, with affected areas differentiated into red, orange and yellow zones according to the number of active cases. Stricter lockdown measures were imposed in red and orange zones, while businesses and

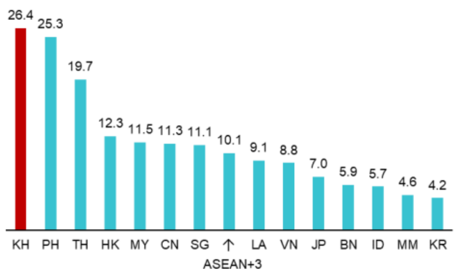
[21] Plans have been put in place to acquire 20 million doses by the end of the year through a combination of donor support and government procurement.
[22] This box was prepared by Paolo Hernando.

factories were allowed to open in yellow zones but with heightened health and safety protocols in place.

Continued vigilance and enhancement of COVID-19 health protocols are needed while ramping up the speed of vaccination. The number of new cases dropped following the government's strong containment measures, but it has steadily risen again since the phased easing of restrictions. This highlights that imposing lockdowns is a temporary solution to stem the surge in infections, allowing the health system to keep pace with rising cases as well as giving authorities time to initiate enhanced safety and health measures. Going forward, the government needs to implement sustained and improved testing and tracing, together with enhanced quarantine measures. Faster vaccination is the key to better protecting lives and preventing further massive waves of infection, facilitating a safe and steady economic reopening. Thus, it is welcome that vaccination has been significantly ramped up, with the aim of fully vaccinating 40 percent of the population by the end of 2021 and achieving widespread immunization by June 2022. Over the medium term, it is important to boost health care capacity to ensure preparedness against future health crisis.

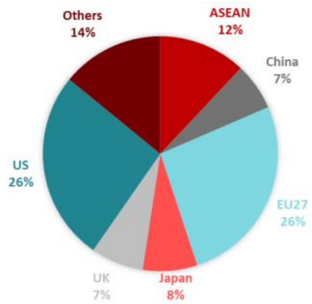
15. Key external risks arise from uncertainties surrounding the evolution and impact of the ongoing pandemic. Given the importance of tourism to Cambodia's economy (Figure 17), the significant uncertainty over the resumption of international travel presents a key risk to the medium-term growth outlook for Cambodia. After falling by over 80 percent in 2020, international tourist arrivals are expected to drop further by 70 percent in 2021. Although Cambodia is laying the groundwork for vaccinated tourists to visit Siem Reap by Q4 2021, prospects for the resumption of international travel remain bleak given the resurgence in infections in many countries as well as the emergence of more infectious variants. [23] Meanwhile, in contrast to the depressed demand from Cambodia's main export markets last year, stronger than expected recovery in the U.S., E.U. and U.K. markets could provide some upside opportunities for higher exports and growth for Cambodia (Figure 18). However, the ability to capture the return of orders could be dampened by increased competition from other labor-intensive garment producers such as Bangladesh and Sri Lanka. Cambodia's competitive edge is also threatened by its long-standing structural constraints (Annex 2: Cambodia's Economic Transformation and Industrial Diversification). In addition, the boost in global trade in combination with shortage of containers, have driven shipping costs to record high levels. This could adversely affect Cambodia's exports of agricultural products, particularly to Europe, if it continues.[24]

Figure 17. Direct and Indirect Contribution of Tourism to GDP, 2019 (% of GDP)



Source: World Travel and Tourism Council; AMRO staff calculations

Figure 18. Exports by Destination (2016-2020)

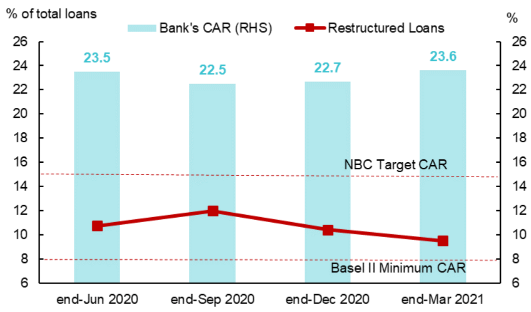


Source: General Department of Customs and Excise (GDCE); AMRO staff calculations

[23] According to the International Air Transport Association (IATA). A full take-off of the tourism sector is expected only in 2023 (https://www.iata.org/en/pressroom/pr/2021-05-26-01/).
[24] The Global Container Freight Index, a measure of container-freight rates in 12 important maritime lanes, has increased from USD2,200 in November 2020 to USD5,165 in May 2021, with the cost of shipping a 40-foot container from Asia to Europe rising more than four times to USD9,478 during the same period. Cambodia's rice exporters have suffered the most, with rice exports falling by 30 percent in the first five months of 2021.

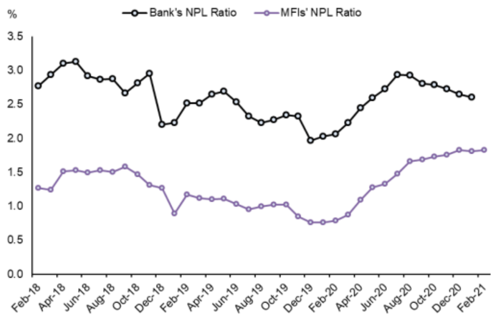
16. Risks in the financial sector may stem from a possible deterioration in credit quality and asset price inflation during the recovery. Given active loan restructuring by financial institutions, the differentiated recovery across sectors is likely to lead to a further deterioration in credit quality. In particular, difficulty in assessing the credit worthiness of restructured loans, combined with the possibility of inadequate provisioning ahead of an eventual unwinding of regulatory forbearance, could lead to a build-up of risks in the financial system. Although restructured loans have declined to below 10 percent of total loans as of end-March 2021 (Figure 19), the recent community outbreak and subsequent lockdowns could increase the demand for continued restructuring and push some existing loans into NPLs (Figure 20)[25], while, the overall capital position and liquidity condition may provide some buffer.[26] Another area that requires the authorities' attention is the risk of asset price bubbles, which may re-emerge once the economic recovery is on firmer footing, particularly if the liquidity from the accommodative monetary stance finds its way to speculative investments in real estate. Prior to the pandemic, there were already growing concerns about rising real estate prices and rapidly increasing credit to real estate related sectors.[27]

Figure 19. Restructured Loans and Capital Adequacy Ratio



Source: NBC; AMRO staff calculations

Figure 20. NPL for Banks and MFIs



Source: NBC; AMRO staff calculations

Authorities' Views

17. *Amid the pandemic, NBC has ramped up monitoring of banks, particularly domestic systemically important banks (D-SIBs) and stand ready to take swift remedial measures in case signs of stress emerge. In terms of strengthening the liquidity framework of the banking system, the NBC has implemented a liquidity coverage ratio of 100 percent and issued rules on the liquidity risk management framework for banks and financial institutions. Regarding credit quality, the NBC has strengthened the monitoring and recently issued a circular on the assessment, classification and provisioning of restructured loans. The circular directs banks to reassess credit worthiness of borrowers, particularly those that have restructured loans and for banks to conduct specific stress tests on the restructured loan portfolio. The NBC encourages banks to proactively provision for restructured loans that appear impaired, rather than wait until regulatory forbearance is lifted. To further enhance monitoring, NBC will conduct targeted on-site inspection of banks, focusing on the credit quality of bank's portfolio of restructured loans.*

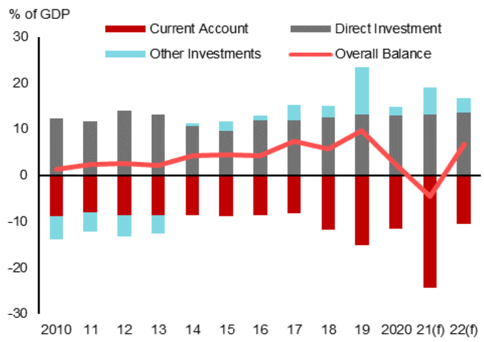
[25] The continued low level of NPLs could be attributed to regulatory forbearance, which have masked some asset quality deterioration during the pandemic. In addition, the IMF (2018) has pointed out the potential under-reporting of NPLs before the pandemic, while continued loan restructuring may also increase the evergreen loans.
[26] Results of a liquidity stress test (Annex 1) using a hypothetical daily withdrawal rate of 10 percent indicate that about 55 percent of banks may face liquidity risks under a severe shock lasting 30 days. According to ASEAN+3 Regional Economic Outlook (2021), CAR would go below the Basel II minimum of 8 percent if the overall NPL ratio would rise above 19.5 percent.
[27] Refer to AMRO Annual Consultation Report Cambodia 2019.

18. *The NBC acknowledges the risk from speculative investments in real estate. However, it views that due to the high openness and dollarization of the economy, liquidity injections done at the onset of the pandemic were not large enough to influence the real estate market. With the slower credit growth to the construction and real estate sector during the pandemic and eventual exit from accommodative monetary policy, NBC does not foresee asset price pressures emerging soon.*

B.2 Longer-term Challenges and Vulnerabilities

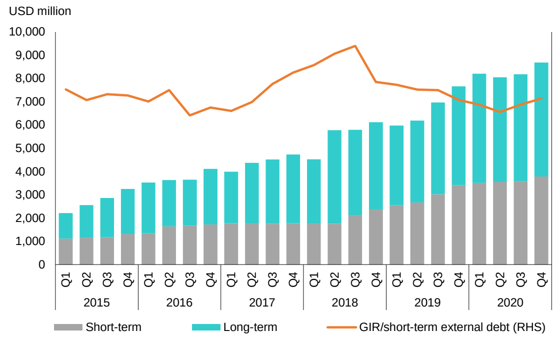
19. Sizeable and sustained current account deficit may increase external vulnerability over the long run. As import demand rebounds in 2021, the current account deficit is forecast to widen sharply to 24.2 percent of GDP, the largest in two decades. Although declining from this peak, the chronic current account deficit is projected to remain sizeable in the medium-term, raising concerns about the continued financing of the large structural current account deficit. Even though robust FDI inflows have been sufficient to finance large current account deficits in the past (Figure 21), FDI has become increasingly reliant on a few countries, especially China. More recently, external borrowing has increased its contribution to Cambodia's balance of payment surplus. [28] Gross external debt by banks has almost quadrupled since 2015, reaching USD8.68 billion at the end of 2020, with a proportional increase in short-term liabilities (Figure 22).[29] Given the persistently high current account deficit, an adverse shock to foreign investment flows or sudden outflow from the banks' short-term deposits could quickly weaken the external position—particularly in view of the lack of capital controls amid a high level of dollarization—leading to a significant drawdown in reserves.

Figure 21. Financing of Current Account Deficit



Source: NBC; AMRO staff calculations

Figure 22. Gross External Bank Debt and International Reserves



Source: NBC; AMRO staff calculations

20. The pandemic may leave long-term scars on Cambodia's growth potential, impeding its quick return to sustainable high growth. Following a long period of high growth, the sudden economic contraction in 2020 poses considerable structural challenges to the economy. Factory and business closures have released a large amount of production factors – labor and capital – which may diminish the strength of recovery in coming years if left underutilized. Unless these idle resources and labor are properly redirected to sectors with growth potential, the economy's productive capacity will decline over time and could experience a permanent damage. In addition, the slow progress in developing public

[28] External debt increased to 65.3 percent of GDP in 2020, from 56.5 percent of GDP in 2019. External debt is composed of concessional borrowing by the government and commercial banks' external liabilities, at 33.1 percent and 32.2 percent of GDP respectively.
[29] The rise in bank external liabilities has been generally in line with the robust expansion of financial sector with continued financial deepening amid high level of dollarization. However, increasing short-term liabilities are partly attributable to the short-term fund inflows by foreign banks into their branches in Cambodia to take advantage of relatively higher interest rates.

infrastructure and improving the regulatory environment tends to keep non-labor operational costs high. This could diminish the competitiveness of Cambodia, limiting its ability to attract more FDI in the post-pandemic period, thereby lowering its long-term growth potential.

C. Policy Discussions and Recommendations

C.1 Targeted and Flexible Fiscal Policy

21. Proper administrative infrastructure enabled the government's quick policy responses during the pandemic. AMRO commends the government's timely policy responses and progressive roll-out of various support measures, which have been responsive to the evolving challenges brought about by the pandemic. Having proper identification and welfare systems in place was found essential to enable the government to quickly scale up its support programs to vulnerable households, particularly the cash transfer (Box C).[30] Appropriate administrative information also led to the more effective implementation of expanded support programs with less administrative ambiguity.[31]

Box C. Cash Transfer Program for Poor and Vulnerable Households during COVID-19[32]

The government of Cambodia implemented the cash transfer program[33] to support poor and vulnerable households linked to the IDPoor system. This cash transfer program is an extended anti-poverty intervention enhancing the existing subsidies already received by the identified beneficiaries in the Social Protection Assistance programs under National Social Protection Policy Framework (NSPPF). Implementation of cash transfer was greatly facilitated by the IDPoor system which is designed by the Ministry of Planning (MoP). IDPoor system covers mostly rural areas, and is based on village level procedures and scoring system, classifying households into "poor" (IDPoor2), "very poor" (IDPoor1) and "non-poor".[34] The IDPoor database is constantly updated by the MoP and as of January 2021, a total of 2.8 million poor individuals had been registered in IDPoor database, achieving 92 percent of the project's target, while it is only approximately 35 percent of total estimated poor individuals in Cambodia.[35] The cash transfer program is fully financed through the national budget, with USD300 million and USD200 million earmarked for 2020, and 2021 respectively.

The COVID-19 cash transfer program is a monthly allowance for qualified households starting from July 2020. The program is implemented through the coordination among the National Social Protection Council, the Ministry of Social Works, Veteran Affairs and Youth Rehabilitation, the MoP, and the Ministry of Economy and Finance (MEF). As of 24 May, 2021 five rounds of cash transfers had been rolled out, and the last round scheduled for June, 2021 as seen in Table C1. Households identified as "very poor" or "poor" and those with Health Equity Fund cards[36] are considered eligible beneficiaries for the COVID-19 cash transfer program. The beneficiaries would receive cash transfers via mobile payment accounts through Wing, a mobile banking service provider. The funds can then be withdrawn from over 7,000 money transfer agents nationwide.

[30] The cash transfer program budget expanded 30 times during the pandemic, from USD 10 million in 2019 to USD300 million in 2020. Amid the massive expansion of the program, the existing IDPoor system proved robust in being able to identify and provide sufficient coverage of poor households targeted by the expanded social assistance program.
[31] For example, 82.3 percent of the budgeted spending for affected households and firms was disbursed in 2020, while for the intervention aimed at providing liquidity and credit support, only 55 percent of the target was implemented as of end-December 2020.
[32] This box was prepared by Madeleine D. Vinuya and Sotheareach Sok.
[33] Sub Decree No.88 was announced on June 12, 2020 for the implementation of "Cash Transfer Program for Poor and Vulnerable Households during COVID-19"
[34] The IDPoor program was established in 2011, tasking the Ministry of Planning to coordinate and monitor the identification of poor households, as well as collect, analyse, and disseminate data thereafter. The program's identification system is based on anti-poverty measures that go beyond income and takes into account broader measures of deprivation as documented in OECD (2017).
[35] Based on OECD (2017) estimate of poor households in Cambodia.
[36] Health Equity Cards are barcoded cards of the Health Equity Fund program, which are handed out to the identified beneficiary of the IDPoor system. HEC card can be presented to social welfare facilities to received care or cash transfers.

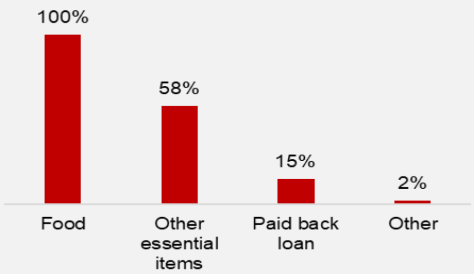
Table C1. Implementation Schedule and Disbursement for the Cash Transfer Program

Round	Month	No. of Families	No. of family members	Amount disbursed (in USD)	Total disbursed as of end-period (in USD)
Round 1	1st - July 2020	530,838	2,153,114	23,637,969	23,637,969
	2nd - Aug 2020	598,512	2,401,319	26,718,564	50,356,533
	3rd - Sept 2020	644,665	2,570,695	28,811,535	79,168,068
Round 2	4th - Oct 2020	661,684	2,631,187	29,579,280	108,747,348
	5th - Nov 2020	674,146	2,676,740	30,128,101	138,875,449
Round 3	6th - Dec 2020	681,999	2,707,253	30,503,735	169,379,184
	7th - Jan 2021	685,447	2,720,345	30,660,725	200,039,909
Round 4	8th - Feb 2021	688,539	2,731,161	30,539,052	230,578,961
	9th - Mar 2021	692,092	2,744,301	30,669,348	261,248,309
	10th - Apr 2021	693,333	2,748,639	30,731,537	291,979,846
Round 5	11th - May 2021	693,933	2,750,501	30,831,118	322,810,964

Source: Ministry of Economy and Finance
Note: The exchange rate used is 1USD=4,000KHR. USD=United States dollar; KHR=Cambodian riel.

A total of USD322.8 million was disbursed to 2.7 million beneficiaries as of May 11, 2021. The expansion of the cash transfer program had also been fast tracked during the crisis. According to Karamba and Tong (2020)[37] using High-Frequency Phone Survey conducted from August to November 2020, the share of IDPoor households that received social support between June to August increased from 50 percent to 91 percent, and to 92 percent by October 2020. Most IDPoor households have reportedly received an average of USD133 in three instalments, averaging a monthly stipend of USD44. Households classified as "poor" received an average of USD 52 per month, while households classified as "very poor" received USD67 per month. Most beneficiaries reported using the cash transfers for food and essential consumables (See Figure C1).

Figure C1: Percentage of Households That Spend on Different Expenditure Categories



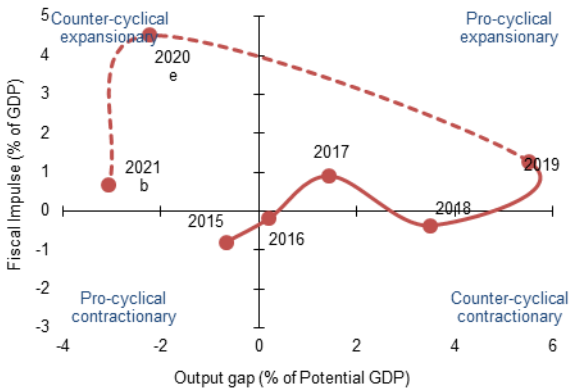
Source: Karamba and Tong (2020)

The cash transfer program is still limited in its coverage and amount, but is being planned for expansion. UNDP (2020)[38] estimates that poverty incidence would have doubled in 2020 without the cash transfer program and policy interventions, rising from a pre-pandemic level of 9.6 percent to 17.6 percent by the end of 2020. However, the program's coverage still remains limited. The IDPoor system is estimated to cover about 65 percent of the poor in Cambodia, and individuals that have fallen into poverty due to the pandemic may not be fully registered in the system. Moving forward, the cash transfer program will be expanded to include pregnant women and children, and is set to begin pilot projects in selected priority provinces that have a high food insecurity rate. There are also plans for a comprehensive database management system to have a single window for registration which will then be linked to the IDPoor system.

[37] Karamba, Wendy and Kimsun Tong (2020) The Socioeconomic Impacts of COVID-19 on Households in Cambodia, World Bank.
[38] UNDP (2020) "Meeting the Costs and Maximizing the Impact of Social Protection in Cambodia".

22. Given the slow and uneven recovery in an environment of high uncertainty, more targeted and flexible fiscal policy support is required. Fiscal policy is budgeted to remain expansionary in 2021 with a slightly higher fiscal deficit of 7.6 percent of GDP (Figure 23) while revenue target remains very conservative. As near-term economic recovery is expected to be uneven across sectors with sizeable downside risk, fiscal support measures should be made more targeted with greater flexibility. In particular, elevated uncertainties about repeated waves of community outbreaks underscore the importance of flexible implementation of fiscal support measures to respond quickly to evolving needs of those most vulnerable, while also bolstering the economic recovery.[39] In sectors with prolonged economic distress, a review of program relevance and effectiveness should be conducted regularly so that adjustments can be made.

Figure 23. Fiscal Stance



Sources: Ministry of Economy and Finance (MEF); AMRO staff estimates.

Authorities' Views

23. *In light of the surge in COVID-19 infections, the government has announced its plan to expand the stimulus package for 2021 to USD 1,454 million from the initial allotment of USD 719 million which will be fully financed by a drawdown of USD 1,500 million from fiscal reserves. This additional stimulus package is expected to be used to increase health spending and extend the existing fiscal support measures, including the cash transfer program, until end-December 2021. If fully realized, the expanded stimulus package is forecast to increase the fiscal deficit by 2.6 percentage points of GDP in 2021.*

24. Fiscal policy focus should gradually shift away from short-term crisis support towards strengthening the country's medium-term economic resilience. As the economic recovery gains momentum, existing short-term crisis support measures should be carefully reviewed and recalibrated to focus more on bolstering economic recovery, while ensuring continued support for priority target groups. For example, emergency wage subsidies could be gradually scaled back and replaced with expanded vocational and skills training programs to help displaced workers upskill and reskill. This will assist them in finding employment in productive sectors. Additional resources should also be directed to job search and matching programs to facilitate workers' transition towards expanding sectors and to reduce frictions in the job market. In parallel, the COVID-19 cash transfer program could be

[39] Given very conservative budget revenue projection by the authorities, AMRO projects a sizeable excess revenue collection which could provide additional policy buffer that could be used in case downside risks materialize with the need for further fiscal stimulus.

transformed into a conditional anti-poverty program helping the progress in Sustainable Development Goals (SDGs).[40]

25. Enhancing revenue and strengthening spending efficiency are crucial in rebuilding fiscal space in the medium-term. Given the planned expansion of domestically-financed public investment projects, the fiscal deficit is projected to decline only gradually over the next five years despite a steady recovery in revenue collection. Public debt is also projected to rise, but will stabilize in the medium-term as the government's fiscal consolidation takes effect. Given its limited policy tools, Cambodia needs to rebuild its fiscal policy buffer for macroeconomic management purpose as government savings have been diminished during the current pandemic. However, resumption of the implementation of Revenue Mobilization Strategy (RMS) II and scheduled tax reforms should proceed cautiously so as not to disrupt the fragile momentum of economic recovery. Furthermore, enhanced revenue collection should be complemented by improving spending efficiency. With the plan to ramp up domestic-financed projects in infrastructure, transportation and digital connectivity, the government must strengthen its efforts to improve the public sector capacity in investment planning and budgeting, monitoring of implementation, and conducting ex-post reviews. These efforts must also be accompanied by enhanced transparency and accountability of fiscal accounts.

C.2 Accommodative Monetary Policy for Economic Recovery

26. Monetary policy should remain accommodative to support the economic recovery. The authorities' swift policy responses at the onset of the pandemic provided vital liquidity support to affected businesses and households, as well as financial institutions. As demand for liquidity remains elevated, accommodative policy measures should be maintained to ensure sufficient funding are available to productive sectors during the recovery. In the medium- and long-term, domestic capital market development would also help provide additional and more affordable financing to corporates. Given limited monetary autonomy under the highly dollarized environment,[41] accommodative monetary policy needs to be complemented by more direct interventions. In particular, the introduction of several government facilities to provide credit to SMEs is commendable. Meanwhile, further efforts are needed to enhance the risk management of these government facilities and help SMEs upgrade their financial capacities (Box D).[42]

Box D. Government Policies for Micro, Small and Medium Enterprise (MSMEs) Development[43]

MSMEs development has been a key long-term strategic goal for different reasons. It can boost employment, contribute to poverty reduction, and improve Cambodia's value chain resiliency by linking with FDI. In the context of the post-pandemic recovery, various MSMEs support measures have been deployed to address certain crucial structural constraints, including better access to finance.

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[40] Existing anti-poverty programs can be expanded with some conditions to enhance their long-term effectiveness such as regular health check-ups and children's school attendance.
[41] The reduction in interest rates by NBC in March 2020 has not translated to lower bank lending rates, highlighting the difficulty of monetary policy to boost credit under Cambodia's highly dollarized economy. Although there was an initial expansion in KHR liquidity in March--May 2020, the expansion has since been pulled back to maintain exchange rate stability, pushing up KHR financing costs for financial institutions.
[42] The government's key initiatives to boost SME lending in 2021 are the SME Bank's SME Co-Financing Scheme; the Agriculture and Rural Development Bank's lending to SMEs in the agro-processing, agro-industrial and agricultural sectors; and Khmer Enterprise which provides grants to startups in agriculture/agro-processing, handicraft, services and information communication technology (ICT).
[43] This box was prepared by Sotheareach Sok.

The prevalence of informality, combined with many structural constraints, has hindered the development of domestic businesses. Micro enterprises make up 97.6 percent of all business entities, while SMEs and large enterprises account for 2.2 percent and 0.2 percent respectively.[44] Collectively, MSMEs employ over 70 percent of the total workforce in the economy. However, most of them remain informal, with little government regulation. They are also highly concentrated in some traditional sectors such as trading and service businesses. Only 13.9 percent of them are engaged in manufacturing businesses, whose development is increasingly important in domestic industrial diversification. In its effort to support SME development, the government has identified multiple structural constraints to SME development, such as inadequate access to finance, the low rate of formal registration and proper bookkeeping, a lack of technical and regulatory support, limited productivity and innovation, and a lack of skilled labor.

Figure D1: Enterprises by Size (as % of total number of firms)

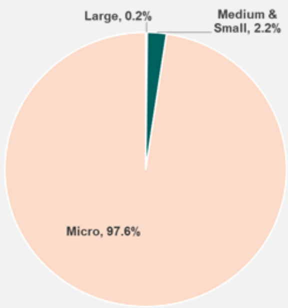


Figure D2: MSMEs by Business Activities (as % of total number of MSMEs)

Source: Cambodia Inter-censual Economic Survey 2014

The government has adopted various measures to address key structural constraints to SME development. The promotion of SMEs is among the key policy priorities in the 4th Rectangular Strategy and the Industrial Development Policy 2015-2025.[45] With the establishment of the SME Policy Action Committee[46] in 2020, the government has deployed a wide range of measures to address structural issues in SME development and to provide support to SMEs during the crisis. In particular, to address limited access to finance, the government established SME Bank and Credit Guarantee Corporation of Cambodia (CGCC) in 2020.[47] [48] Separately, another USD50 million loan program was implemented by Agricultural and Rural Development Bank to support SMEs in agro-processing and other agricultural businesses, and around USD300 million was set aside to support small businesses in the future. Additionally, the Entrepreneurship Development Fund and Khmer Enterprise were launched in 2019 to support local start-ups—especially tech businesses—through an incubation program, grant provision, and the coordination of financing.

The government's SME promotion stretches far beyond better access to finance for businesses. To encourage the formalization of SMEs, tax incentives have been provided to SMEs in priority sectors since 2018.[49] More recently, the government reviewed and updated definitions of SMEs based on the asset size or annual turnover, and the number of employee,

[44] These figures are based on the data with old MSME classification which is based on the number of employees and the asset size only. The government has announced the new classification of MSMEs on 21 January, 2021, which also considers the annual turnover and differences across sectors. (Please refer to footnote 50).
[45] Approved in September 2018, Cambodia's 4th Rectangular Strategy (RS4)—Growth, Employment, Equity and Efficiency— is to lay the foundation for the Cambodia Vision 2050. The Industrial Development Policy 2015-2025 aims to transform and modernize Cambodia's industrial structure from a labor-intensive economy to a skill-driven economy by 2025.
[46] The SME Policy Action Committee is an inter-ministerial committee chaired by the Deputy Prime Minister, Minister of Economy and Finance with the mandate to push forward the government's reform agenda in SME development.
[47] At the first round intervention measures announced on 24 February 2020 by the Prime Minister, the SME Bank and 33 participating financial institutions jointly funded USD100 million worth of loans to support small firms.
[48] Furthermore, in order to ease access to finance for SMEs, a USD200 million Credit Guarantee Fund was launched in late 2020. This was delivered through the fourth round intervention measures announced on 26 May 2020 by the Prime Minister.
[49] Sub Decree No.124 dated 2 October 2018, and Sub Decree No.50 dated 25 March 2019 put forward tax and custom incentives for priority sectors focusing on manufacturing businesses. This included sectors such as agro-processing, food processing, intermediate and finished goods production, technology and innovation, and research and development businesses.

aligning them with actual business contexts.[50] In addition, a number of measures have been initiated to assist SMEs in various business operations. These include the launch of a one-stop business registration platform to expedite business incorporation process, streamlining overlapping inspections and licensing requirements for key sectors, and increasing efforts to combat cross-border smuggling activities to ensure a level playing field. Going forward, the government plans to mobilize investment in the SME cluster and the domestic packaging sector, digitalize SMEs and continue investing towards supporting infrastructure, especially in the areas of logistics and transportation.

C.3 Enhanced Bank Supervision and Regulation for Financial Stability

27. Enhanced supervision and a well-communicated exit plan will help maintain financial sector stability. Regulatory forbearance has provided an effective temporary relief to financial institutions, but proper assessment of potential credit risks has become more challenging. With the ongoing loan restructuring program, authorities should continue to closely monitor credit risk developments at banks, particularly those with thin capital buffers or high exposure to the risky sectors.[51] This will help authorities deploy appropriate measures in a timely manner to safeguard financial stability. When conditions warrant, the withdrawal of regulatory forbearance should be gradual and based on a well-communicated plan to reduce uncertainties. This will enable financial institutions to prepare for any increase in provisions and other adjustments as needed. In addition, financial institutions should be encouraged to strengthen their forward-looking risk management tools in line with international best practices. Likewise, the normalization of liquidity measures should be carefully phased, so that sufficient funding remains available during the economic recovery, while the authorities should ensure that vulnerable banks strengthen their liquidity management. As the economy rebounds, the authorities also need to closely monitor asset prices and leverage conditions, and deploy prudential measures such as loan-to-value limits and sectoral risk weights to curb risks as required.

C.4 Structural Reforms Towards Greater Economic Resilience

28. Coordinated efforts to address structural constraints should be accelerated to boost competitiveness and resilience of the economy. To enhance the resilience of economy, the authorities should continue efforts for diversification, including the development of domestic industries and attracting more FDIs into priority sectors. The new Investment Law will help create a more supportive environment, but stronger policy efforts are necessary to make Cambodia's business environment more competitive to attract quality investors and foster new growth drivers in priority sectors.[52] In particular, properly addressing structural constraints in public infrastructure, skilled labor supply and institutional environment is critical in improving Cambodia's competitiveness and upgrading its long-term growth potential.[53] This

[50] The government Circular No. 36 (21 January, 2021) provides the new classification of MSMEs based on the number of employees and the asset size or annual turnover, with different thresholds for agriculture, industry, and services and trade sectors. The small enterprises employ 5-49 staffs and have assets of between USD 50,000 and 250,000 or the annual turnover of USD 62,250 and 250,000; the medium enterprises employ 50-199 staff and have the assets of between USD 250,001 and 1,000,000 or the annual turnover between USD 250,001 and 2,000,000. The enterprises below the small enterprises are classified as the micro enterprises.

[51] The NBC has identified four severely affected sectors by the pandemic, namely, tourism, garment, construction and transportation, which account for 48 percent of restructured loans.

[52] Plans to develop priority sectors are in several key documents, particularly the ICT Master Plan 2020, the Cambodia Industrial Development Policy 2015-2025, and the Agriculture Sector Master Plan 2030. Although the new investment law has yet to be passed, initial draft indicates the following priority sectors: high-tech industry and digital sector, logistics, green energy, electrical and electronic assembly and parts, mechanical and machinery assembly and parts, agro-industry, agro-processing, tourism, education and vocational training, health sector, and infrastructure development, among others.

[53] Cross country comparisons show Cambodia's relative weaknesses in regulatory and legal environment (such as rule of law, protecting minority investors, starting a business, enforcing contract, IPR protection) as well as human capital (low labor productivity, low skills) and public infrastructure (high electricity cost, high logistic cost). See Annex 2: Cambodia's Economic Transformation and Industrial Diversification.

in turn requires strong policy coordination among relevant government ministries, as well as close engagement with the private sector. The expansion of trade agreements could also provide a boost to Cambodia's pursuit of economic diversification, as the improved access to different markets would help attract more FDIs, promoting domestic investment and production that could help absorb additional resources in the post pandemic period.[54] It is equally important to resume the delayed plan in achieving SDGs by reprioritizing policy support for long-term development issues, such as social safety nets as well as public health and education, which could facilitate the implementation of structural reforms to ensure sustainable and resilient growth in the medium- and long-term.

Box E. Promoting Fintech Development for Financial Inclusion in Cambodia [55]

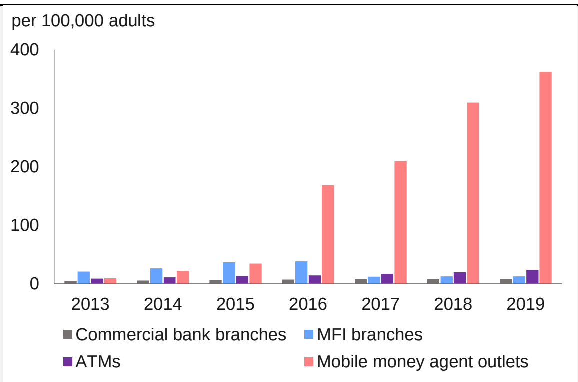
Cambodia has experienced notable fintech development over the last decade, particularly in digital payments and transfers. In line with the government policy priority towards digital transformation, the NBC has encouraged the development and provision of digital financial services to improve efficiency in the payment and banking system and promote financial inclusion. The NBC has amended its regulatory frameworks to support innovation and startups in the banking system, especially in the area of mobile payment services, while preserving financial stability and monitoring any potential risks. In addition, Cambodia's relatively large share of young population[56] and high mobile phone and internet penetration[57] have attracted fintech firms to introduce innovative e-wallet and mobile money services with their agent network across the country. This has allowed more and more unbanked people to access and use formal financial services at low cost. Banks and MFIs have also leveraged partnerships with payment service institutions to lower their operational costs and developed their own mobile and internet banking services to be more convenient, secure and attractive.

Mobile money services have been growing fast. Despite a late start, the number of mobile money agents has increased markedly, reaching 362.3 per 100,000 adults in 2019, much higher than that of bank branches (43.6 times), MFI branches (28.3 times) and ATMs (15.6 times) (Figure E1). Moreover, the number of registered mobile money accounts increased to 5.2 million in 2019, outpacing deposit accounts with banks or deposit-taking MFIs (Figure E2). At the same time, the value and number of mobile money transactions also expanded rapidly, reaching 131.3 percent of GDP and 192 million transactions, respectively. This extensive network of mobile money agents has enabled the government to timely deliver digital cash transfers to a large number of workers and households during the COVID-19 pandemic. At the same time, the NBC and financial institutions have encouraged the use of cashless transactions via e-wallets and digital banking platforms, to combat the spread of COVID-19 through paper-based instruments, such as banknotes and cheques.

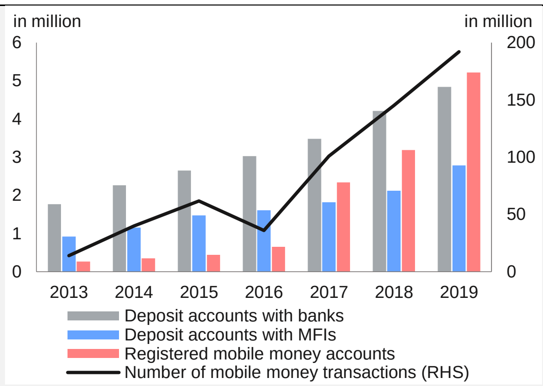
Figure E1. Number of Bank and MFI Branches, ATMs and Mobile Money Agents

Figure E2. Number of Deposit Accounts and Mobile Money Accounts and Transactions

[54] According to MAS Macroeconomic Review (April 2021) Box A: RCEP's Impact on Trade and Growth in the Asia Pacific, although the estimated benefits of RCEP from tariff reduction is expected to be minimal over the next 5 years, benefits are more pronounced in the long-term as common rules of origin may allow Cambodia to better integrate into global and regional supply chains.
[55] This box was prepared by Yuthan Chea.
[56] General Population Census 2019 indicated that more than 70 percent of population are below 40 years old and the median age is 27.
[57] The Telecommunication Regulator of Cambodia (TRC) reported that the number of mobile phone subscriptions in Cambodia was almost 21 million and the number of internet subscriptions was 17.8 million as of March 2021. (https://www.trc.gov.kh/en/mobile-phone-subcribers/; https://www.trc.gov.kh/en/internet-subcribers/)



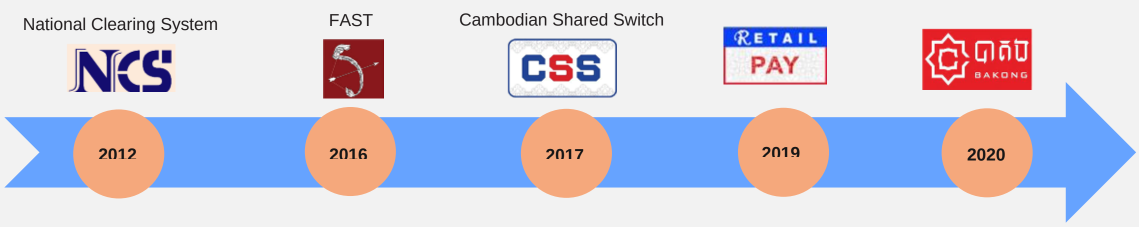
Source: IMF Financial Access Survey



Source: NBC; IMF Financial Access Survey

New digital infrastructures have been introduced to support rapidly expanding digital financial services. The NBC has developed new payment and settlement systems over the past decade, including the National Clearing System (NCS), FAST Payment System (FAST), Cambodian Shared Switch (CSS), Retail Pay and Bakong (Figure F3).[58] Recently added Retail Pay is a collection of four systems[59] to improve electronic payments and fund transfers between participating financial institutions. Using distributed ledger technology (DLT), Bakong[60] is a backbone payment system, aiming to enable interoperability among financial institutions, enhance efficiency in payment systems, promote financial inclusion and encourage the use of cashless payments in local currency. Moreover, the NBC has introduced the KHQR Code Standard to enhance the interoperability of QR Code payments among banks and financial institutions within Cambodia as well as in the region.

Figure E3. NBC's Payment Infrastructures



Source: NBC

Some challenges remain in fintech development, such as low financial literacy, cybersecurity threats and fragmented infrastructure. First, low financial literacy can be one of the main obstacles in expanding innovative financial services, especially for the elderly and low-income people living in rural areas.[61] Low financial and digital literacy could limit the use of new financial products, particularly those based on modern technology, thereby limiting their contribution to financial inclusion. Second, cybersecurity threats could affect public confidence and undermine the ability of regulatory authorities to maintain financial stability. With the advancement in digitalization, Cambodia becomes more prone to cybersecurity risk that can cause material disruption in the financial system and loss of public confidence. Lastly, the presence of various payment services in the market offered by similar service providers could lead to inconvenience and confusion among users with limited knowledge of digital and market developments.

[58] The NCS serves as a centralized platform for the settlement of cheques and payment orders, in both KHR and USD. FAST is a real-time fund transfer system in the local currency. CSS enables customers to use payment cards in the ATMs and POS networks of member institutions.
[59] Retail Pay system comprises four sub-systems, namely (i) Real Time Fund Transfer (RFT), (ii) Mobile Payment Service (MPS), (iii) QR Code Payment System (QPS) and (iv) Electronic Clearing System (ECS).
60 Bakong is a blockchain-based payment platform, officially launched by the NBC in October 2020. The PwC CBDC Global Index ranked Cambodia's Bakong project first in Asia and second in the world for retail projects, just after the Bahamas' Sand Dollar.
[61] According to the National Financial Inclusion Strategy 2019-2025, Cambodia has a financial literacy rate of 18 percent, ranked 135th out of 144 countries. This implies that a large share of the population only has limited knowledge and ability to engage with formal financial services.

Going forward, all stakeholders need to continue efforts towards fintech development. Promoting financial and digital literacy is crucial to make people understand how innovative financial products work and to use them. Policymakers and market players can focus on young adults such as students[62] and workers who are keen to adopt digital services and can share knowledge with peers and family members. At the same time, regulators and financial institutions need to establish and adopt proper cybersecurity and consumer protection protocols. Establishing a sound regulatory framework and enhancing supervisory capacity would be priorities for the central bank, such that it can implement policy interventions and ensure stability in the financial system.[63] In addition, the further development of supportive and innovative infrastructure result in greater fintech adoption among financial institutions and customers.

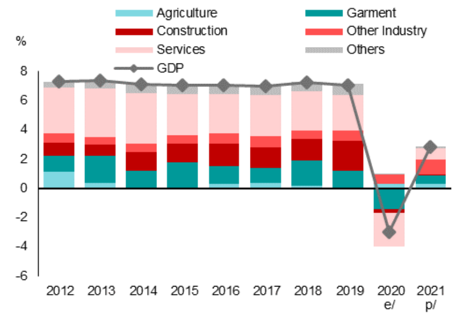
[62] The NBC has cooperated with the Ministry of Education, Youth and Sport to integrate financial literacy programs into school curricula for grades 1 to 12.
[63] The 2020 Annual Report on Payment Systems in Cambodia by the NBC highlighted the need for developing payment infrastructures, preparing regulatory frameworks, enhancing supervision on payment services, and introducing strategic frameworks for cross-border payments and fintech development.

Appendices

Appendix 1. Selected Figures for Major Economic Indicators

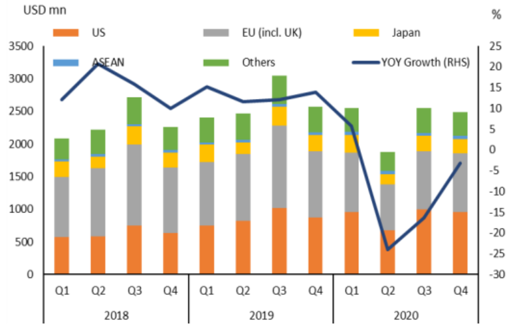
Figure 1.1. Real Sector

Cambodia economy contracted in 2020 due to the pandemic.



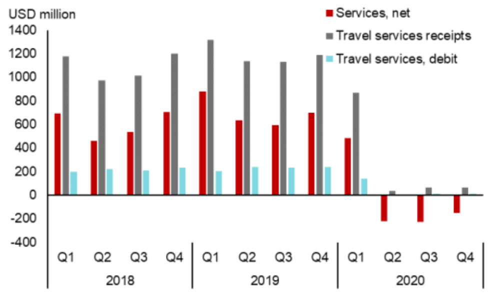
Source: NIS; AMRO staff calculations.

Demand for garments exports contracted.



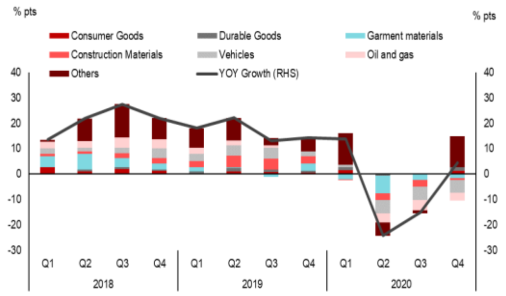
Source: GDCE; AMRO staff calculations.

Border closures have resulted in the collapse of tourism receipts of more than USD1 billion every quarter prior to the pandemic.



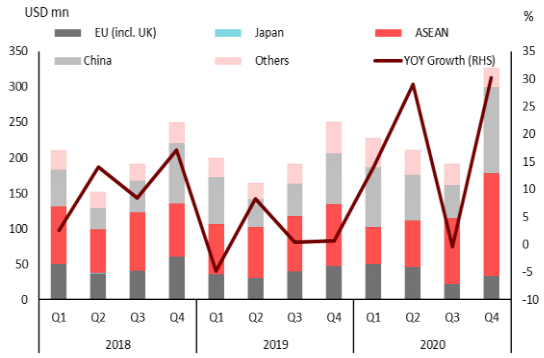
Source: NBC; AMRO staff calculations.

Contraction in consumption reflected in declining imports of vehicles, construction materials, oil and garment materials.



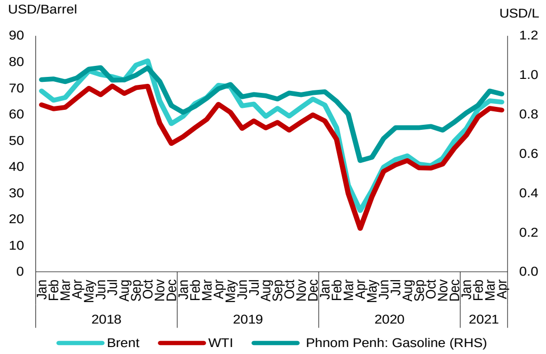
Source: GDCE; AMRO staff calculations.

Agriculture was able to perform well in 2020, supported by strong agriculture exports to China and ASEAN.



Source: GDCE; AMRO staff calculations.

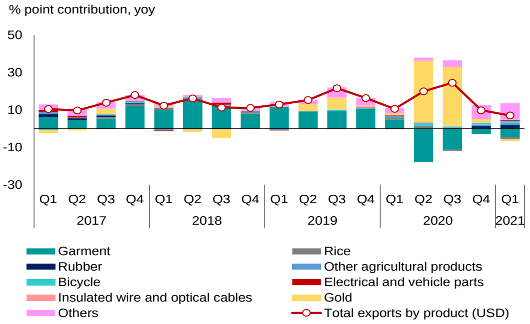
With the rise in global oil prices, rising gasoline prices are expected to be a main driver in pushing up inflation in 2021.



Source: NBC; AMRO staff calculations.

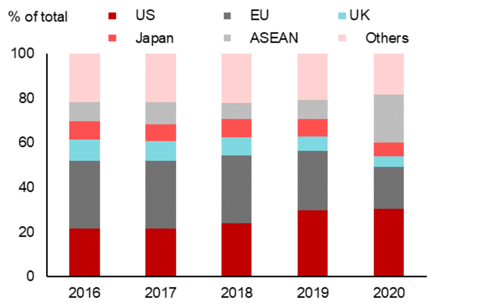
Figure 1.2. External Sector

Exports of garments contracted, but total exports were supported by a one-time increase in gold exports in Q2 and Q3 2020.



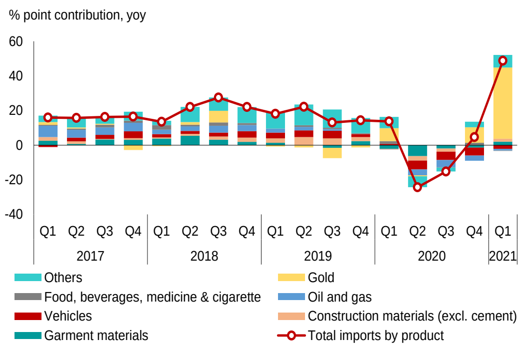
Source: GDCE; AMRO staff calculations.

The US has become Cambodia's top export market in the past two years.



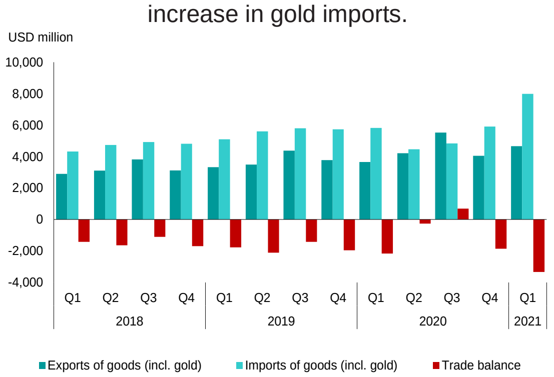
Source: GDCE; AMRO staff calculations.

Imports contracted with the fall in economic activity, but recently expanded mainly due to gold imports.



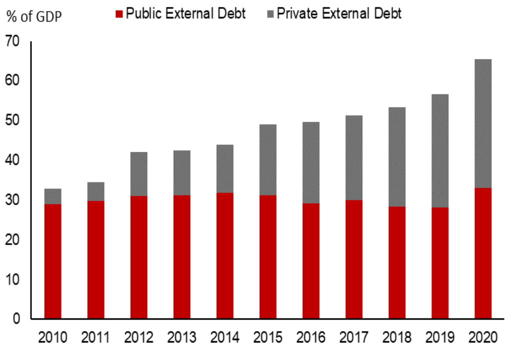
Source: GDCE; AMRO staff calculations.

The trade balance returned to deficit in Q4 2020 and further increased in Q1 2021 with the massive increase in gold imports.



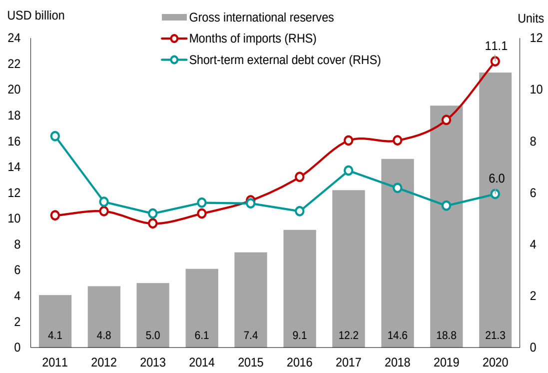
Source: NBC; AMRO staff calculations.

External debt continues to rise, driven mainly by private external debt.



Source: NBC; AMRO staff calculations.

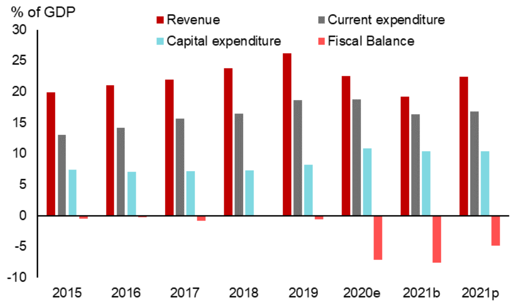
International reserves rose to USD21.3 billion in 2020, covering more than 11 months of imports.



Source: NBC; AMRO staff calculations.

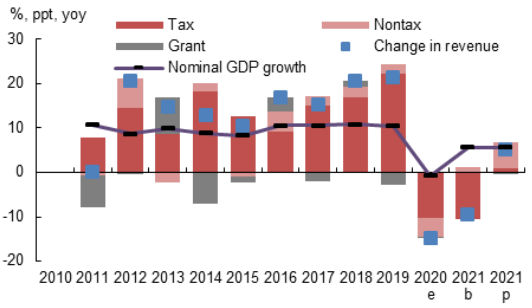
Figure 1.3. Fiscal Sector

The fiscal deficit is budgeted to widen further in 2021, but better revenue collection is projected to narrow the deficit.



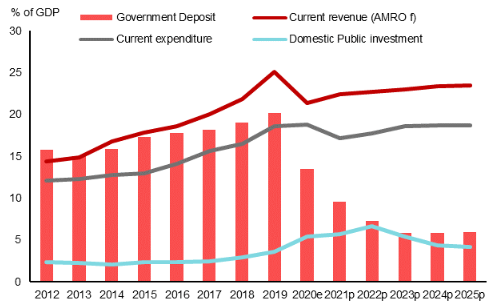
Source: MEF; AMRO staff calculations.

Recovery in revenue collection for 2021 is projected to be driven by gradual economic recovery.



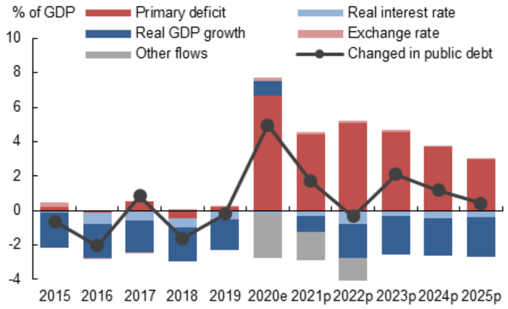
Source: MEF; AMRO staff calculations.

Government savings have been used to finance the stimulus package and fund the planned increase in public investment, thus it is expected to remain low in the medium term.



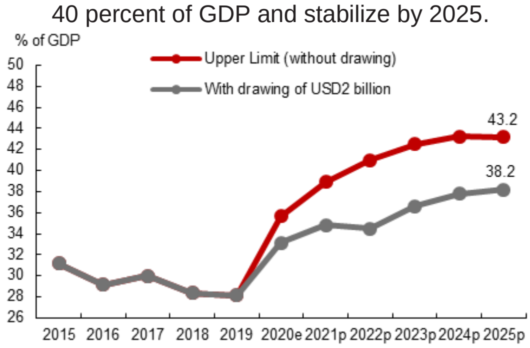
Source: MEF; AMRO staff projection.
Note: Figures from 2021-2025 are based on AMRO projections.

The pace of the debt increase is expected to slow down from 2023 onwards.



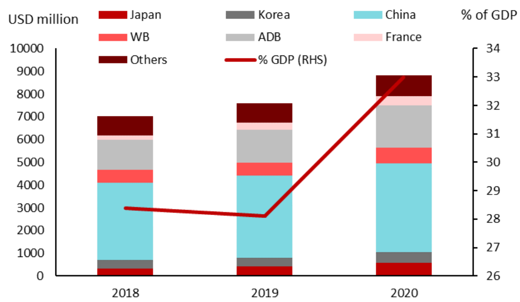
Source: MEF; AMRO staff calculations.
Note: Figures from 2021-2025 are based on AMRO projections.

With drawings from fiscal reserves and steady fiscal consolidation, public debt will remain below 40 percent of GDP and stabilize by 2025.



Source: MEF; AMRO staff calculations.
Note: Figures from 2021-2025 are based on AMRO projections.

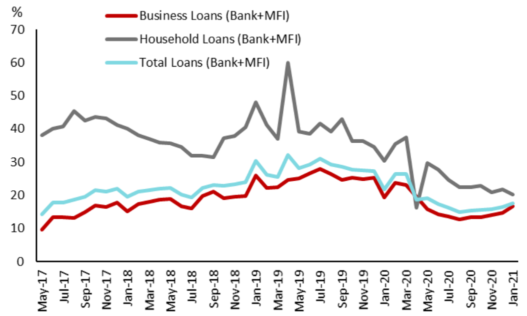
Public debt rose to 33.1 percent of GDP in 2020 from 28.1 percent of GDP in 2019, with the largest share from China and ADB.



Source: MEF; AMRO staff calculations.

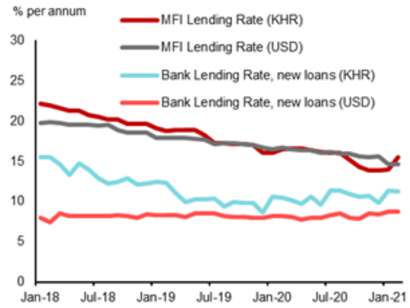
Figure 1.4. Monetary and Financial Sectors

Loan growth remained slow in 2020, but business loans gradually picked up from H2 2020.



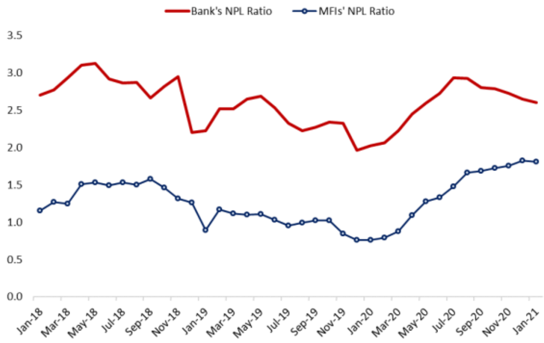
Source: NBC; AMRO staff calculations.

A slight upward trend in bank and MFI lending rates may reflect higher risk premiums and rising financing costs due to the pandemic.



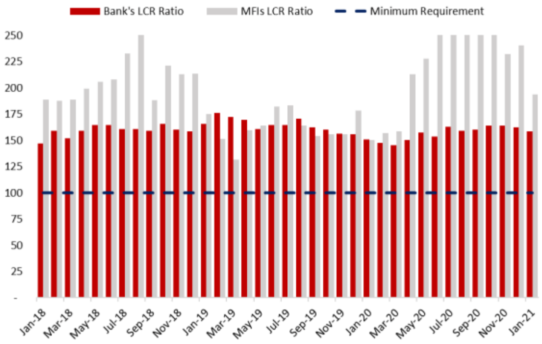
Source: NBC; AMRO staff calculations.

Overall NPLs remained relatively low, in part due to the regulatory forbearance on restructured loans.



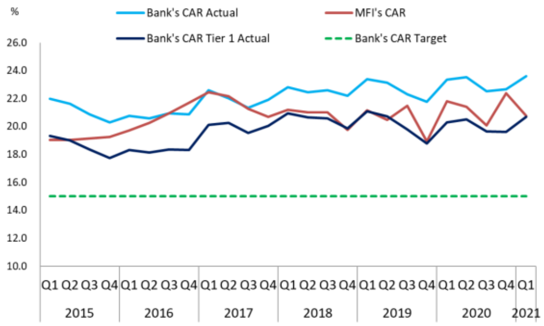
Source: NBC; AMRO staff calculations.

With the NBC's early intervention, liquidity remained ample at both banks and MFIs.



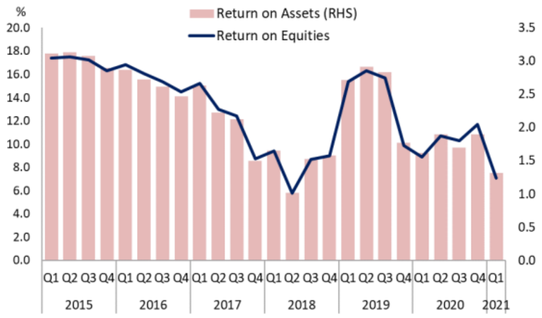
Source: NBC; AMRO staff calculations.

Both banks and MFIs are well capitalized, with CARs well above the minimum requirement level set by the NBC.



Source: NBC; AMRO staff calculations.

Both ROA and ROE fell in Q1 2021 as the impact of the pandemic continue to weigh on bank operations and income.



Source: NBC; AMRO staff calculations.

Appendix 2. Selected Economic Indicators for Cambodia

	2017	2018	2019	2020	Projections	
					2021	2022
Real Sector and Prices	**(In annual percentage change)**					
Real GDP[1/]	7.0	7.5	7.1	-3.1	2.8	6.8
Agriculture	1.7	1.1	-0.5	0.6	1.6	1.8
Industry	9.8	11.0	11.3	-1.4	4.5	9.5
Services	7.0	6.8	6.2	-6.5	2.2	6.4
GDP deflator	3.3	3.3	3.2	2.3	2.7	2.9
CPI inflation (average)	2.9	2.5	1.9	2.9	3.3	2.3
CPI inflation (end of period)	2.0	1.6	3.1	2.9	3.1	2.2
External Sector	**(In millions of USD, unless otherwise specified)**					
Current account balance	-1,800	-2,894	-4,063	-3,077	-6,787	-3,253
(In percent of GDP)	-8.1	-11.8	-15.0	-11.5	-24.2	-10.6
Trade balance	-4,278	-5,844	-7,255	-3,593	-7,923	-5,289
Exports	11,224	12,963	14,987	17,457	15,988	18,073
Imports	15,502	18,806	22,242	21,050	23,911	23,363
Services, net	1,863	2,395	2,812	-124	209	1,235
Primary income, net	-1,141	-1,331	-1,565	-1,013	-966	-1,267
Secondary income, net	1,756	1,885	1,945	1,654	1,892	2,068
Financial account balance	3,671	3,977	6,725	4,123	5,552	5,352
Foreign Direct Investment	2,673	3,089	3,561	3,498	3,748	4,188
Other Investment	725	604	2,821	462	1,652	1,012
Overall balance	1,631	1,445	2,668	637	-1,236	2,098
Gross international reserves	12,201	14,629	18,763	21,334	20,098	22,197
(In months of imports)	8.0	8.0	8.8	11.1	9.1	10.2
External debt	11,364	13,093	15,303	17,434	19,196	21,031
(In percent of GDP)	51.2	53.3	56.5	65.3	68.2	68.4
Fiscal Sector	**(In percent of GDP)**					
Revenue and grants	21.9	23.8	26.2	22.5	22.4	23.3
Tax revenue	17.3	19.0	22.0	19.4	18.6	19.5
Nontax revenue	2.9	3.1	3.3	2.2	3.0	3.0
Grants	1.7	1.8	1.0	1.0	0.9	0.8
Expenditure	22.8	23.8	26.9	29.6	27.4	28.9
Current non-interest expenditure	15.3	16.1	18.3	18.4	16.4	17.2
Interest payments	0.4	0.4	0.4	0.4	0.5	0.5
Capital expenditure	7.2	7.3	8.2	10.8	10.5	11.2
Overall fiscal balance	-0.9	0.0	-0.6	-7.1	-5.0	-5.6
Primary balance	-0.7	0.2	-0.4	-6.7	-4.4	-5.1
Public debt	30.0	28.4	28.1	33.1	34.8	34.5
Monetary and Financial Sector	**(In annual percentage change, end-period)**					
Domestic Credit	15.6	21.1	24.4	19.1	20.4	23.5
Credit to private sector	18.5	23.2	24.3	17.7	19.7	21.8
Broad money	23.8	24.0	25.5	15.3	19.0	21.2
Reserve money	19.3	13.3	15.2	11.6	14.1	16.7
Memorandum Items						
Nominal GDP (KHR billion)	89,831	99,544	110,014	109,238	115,396	126,885
Nominal GDP (USD million)	22,177	24,572	27,089	26,690	28,083	30,756
GDP per capita (USD)	1,429	1,555	1,694	1,601	1,656	1,813
Exchange rate (KHR/USD, average)	4,051	4,051	4,061	4,093	4,109	4,126
Exchange rate (KHR/USD, end of period)	4,042	4,033	4,084	4,077	4,101	4,126

Source: National authorities; AMRO staff estimates
Note: 1/ GDP data for 2020 and onwards are AMRO staff estimate and projections

Appendix 3. Balance of Payments

	2015	2016	2017	2018	2019	2020
	(in millions of USD)					
Current account	**-1,598**	**-1,733**	**-1,800**	**-2,894**	**-4,063**	**-3,077**
Trade balance	-3,949	-3,846	-4,278	-5,844	-7,255	-3,593
Exports, f.o.b.	9,336	10,273	11,224	12,963	14,987	17,457
Imports, f.o.b.	13,285	14,119	15,502	18,806	22,242	21,050
Services, net	1,712	1,602	1,863	2,395	2,812	-124
Receipts	3,955	4,033	4,608	5,451	6,086	1,945
Payments	2,242	2,430	2,745	3,056	3,274	2,069
Primary income, net	-998	-1,050	-1,141	-1,331	-1,565	-1,013
Receipts	354	377	442	578	731	668
Payments	1,352	1,427	1,582	1,908	2,296	1,682
Secondary income, net	1,636	1,561	1,756	1,885	1,945	1,654
of which: official tranfer	526	506	550	579	532	449
Others	1,110	1,056	1,206	1,306	1,413	1,205
Capital and financial account	**2,382**	**2,901**	**3,671**	**3,977**	**6,725**	**4,123**
Capital account	265	283	279	326	355	260
Financial account (net)	2,117	2,618	3,393	3,651	6,370	3,863
Direct investment	1,735	2,397	2,673	3,089	3,561	3,498
Other investment	397	223	725	604	2,821	462
Errors and omissions	47	296	241	362	163	-409
Overall balance	831	873	1,631	1,445	2,668	637
Memorandum items:						
Exports of goods and services	13,291	14,306	15,832	18,414	21,073	19,402
Imports of goods and services	15,528	16,550	18,247	21,862	25,516	23,119
Trade account (% GDP)	-21.9	-19.2	-19.3	-23.8	-26.8	-13.5
Current account (% GDP)	-8.9	-8.7	-8.1	-11.8	-15.0	-11.5
Capital and financial account (% of GDP)	13.2	14.5	16.6	16.2	24.8	15.5
Overall Balance (% of GDP)	4.6	4.4	7.4	5.9	9.8	2.4
International reserves (In millions of USD)	7,377	9,123	12,201	14,629	18,763	21,334
In months of imports of goods and services	5.7	6.6	8.0	8.0	8.8	11.1
GDP (In millions of USD)	18,050	20,017	22,177	24,572	27,089	26,690

Source: National authorities; AMRO staff calculations.

Appendix 4. Statement of General Government Operations

Items	2015	2016	2017	2018	2019	2020	2021BL
	(in percent of GDP)						
Total Revenue and Grants	19.9	21.0	21.9	23.8	26.2	22.5	19.3
Total Domestic Revenue	18.0	18.7	20.2	22.1	25.3	21.6	18.6
Central Govt	16.8	17.7	19.0	20.4	23.2	19.7	17.3
Local Govt	1.1	1.0	1.2	1.6	2.0	1.9	1.3
Current Revenue	17.8	18.6	20.1	21.9	25.1	21.4	18.4
Total Tax Revenue	15.8	15.9	17.3	19.0	22.0	19.4	16.1
Tax Revenue Central	14.8	15.0	16.2	17.4	20.0	17.6	15.2
Domestic Taxes	12.2	12.5	14.0	15.0	17.4	15.6	13.2
Direct Taxes	3.4	3.6	4.2	4.1	4.6	5.3	3.7
Indirect Taxes	8.4	8.9	9.7	10.9	12.8	10.3	9.5
VAT	5.0	5.2	5.5	5.8	7.4	5.6	5.4
Excise	3.5	3.7	4.2	5.2	5.4	4.1	4.0
Trade Taxes	2.6	2.5	2.2	2.4	2.6	2.0	2.0
Tax Revenue Local	1.0	0.9	1.1	1.6	1.9	1.8	0.9
Non-tax revenue Central	1.9	2.6	2.7	2.9	3.0	1.9	1.9
Non-tax revenue Local	0.1	0.1	0.1	0.0	0.1	0.1	0.4
Capital Revenue	0.2	0.1	0.2	0.2	0.2	0.2	0.2
Grants	1.9	2.3	1.7	1.8	1.0	1.0	0.9
Total Expenditure	20.4	21.3	22.8	23.8	26.9	29.6	26.9
Current Expenditures	13.0	14.2	15.6	16.5	18.3	17.1	16.5
Wages and Salaries	6.2	6.8	7.6	8.0	7.4	7.8	7.4
Non-wages	5.4	5.9	6.4	6.7	8.9	7.6	7.3
Interest Payment	0.3	0.4	0.4	0.4	0.4	0.4	0.5
Domestic	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	0.3	0.4	0.4	0.3	0.4	0.4	0.5
Capital Expenditures	7.4	7.1	7.2	7.3	8.2	10.8	10.5
Domestic Financed	2.4	2.4	2.5	3.0	3.6	3.7	5.7
Foreign Financed	5.1	4.7	4.7	4.3	4.6	5.5	4.7
Current Balance (excl. grant)	4.8	4.4	4.4	5.4	6.8	4.3	1.9
Primary Balance (excl. grant)	-2.1	-2.1	-2.2	-1.3	-1.2	-7.6	-7.8
Fiscal Balance (incl. grant)	-0.5	-0.3	-0.9	0.0	-0.6	-7.1	-7.6
Fiscal Balance (excl. grant)	-2.4	-2.5	-2.6	-1.7	-1.6	-8.1	-8.3

Sources: National authorities and AMRO staff calculations

Note: 2021 GDP share is based on AMRO's projection.

Appendix 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 and Labor Market	- GDP numbers on the production and expenditure side have been made available - Unemployment and labor market data are available on the website	- The dissemination of GDP data is on an annual basis with a time lag of three to seven months - Data on the labor market has a lag of more than one year	National Accounts statistics are compiled broadly in accordance with SNA93 standards. Data collection techniques remain weak due to resource constraints. The authorities plan to release the GDP data based on SNA 2008.	Revisions are frequent but becoming less significant. Officially, the statistical discrepancy is also shrinking	- The data quality of the National Accounts data could be improved using a more comprehensive Supply Used Table (SUT) based on the latest survey - The GDP data on the expenditure side remains relatively weak with underestimated gross fixed capital formation
Balance of Payments (BOP) and External Position	- BOP data is published on the NBC website - Import and export data is published by the MEF - Import data breakdown by category, destination and origin is not yet available	- BOP data is released on a quarterly and yearly basis with a time lag of one to three quarters - Trade data is released on a monthly basis with a time lag of one month.	- Since 2019, the BOP has been published in conformity with the BPM6 but some coverage limitations exist - Import data published by the MEF is incomplete, as it covers only major items	-	-
State Budget and Government/ External Debt	- Budget implementation data is released on the MEF website - Budget implementation data does not include local government budget operation - 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 breakdown of budget implementation data from TOFE is different from the one provided by the GD of Budget.	-
Money Supply and Credit Growth	- CPI data for Phnom Penh is published by the NIS - National CPI data is yet to be made available - Monetary statistics have been released on the NBC website - Data on credit breakdown by sector is also available	- CPI data is released on a monthly basis with a time lag of one to three months - Monetary and credit data is published on a monthly basis with a time lag of three months.	- The compilation of the CPI suffers from insufficient coverage - The authorities plan to release CPI data with much wider 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	- Foreign assets and liabilities for the banking sector in aggregate are published by the NBC - A detailed breakdown of the composition of foreign assets and liabilities of the banking sector is not yet available	Yearly data is released on the NBC website with a time lag of three to six months	- Indicators are generally based on reports from banks and MFIs - In addition to banking indicators, data on microfinance activities is lacking	-	The availability of more comprehensive and more frequent data, including a 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 time interval that the available data are published. Timeliness refers to how up-to-date the published data are relatively with the publication date.
(iii) Data quality refers to the accuracy and reliability of the available data given the data methodologies are taken into account.
(iv) Consistency refers to both internal consistency within the data series itself and its horizontal consistency with other data series of either same or different categories.
(v) Other criteria might also apply, if relevant. Examples include but are not limited to potential areas of improvement for data adequacy.

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

Annexes: Selected Issues

Annex 1. Liquidity Stress Test for Cambodia's Banking Sector[64]

1. **At the start of the pandemic, the National Bank of Cambodia (NBC) quickly rolled out liquidity support measures and issued guidelines on regulatory forbearance.** These measures helped financial institutions stay afloat and provide financial support to those affected by the pandemic (Box A1). Against this backdrop, this selected issue examines liquidity risk by testing the banking system's resilience against bank runs under various scenarios.

Box A1. NBC's COVID-19 Policy Responses

Additional liquidity provision to financial institutions (Announcement No. B13-020-002 dated 17 March 2020). The NBC announced four supporting guidelines to provide additional liquidity to financial institutions.

1. Postpone the full implementation of Capital Conservation Buffer (CCB);
2. Reduce the minimum interest rate of Liquidity Providing Collateralized Operation (LPCO) by 0.5 percent for all maturities;
3. Decrease the interest rate for Negotiable Certificates of Deposit (NCD) in KHR and USD within appropriate limits;
4. Reduce the Liquidity Coverage Ratio (LCR) requirement to an appropriate level as needed.

The reduction of reserve requirements on financial institutions' deposits and borrowings (Prakas No. B7-020-230 dated 18 March 2020). Under this Prakas, financial institutions' reserve requirement ratio (RRR) on deposits and borrowings shall be reduced to 7 percent of daily average balance – down from 8 percent for riel liabilities and 12.5 percent for foreign currency liabilities.

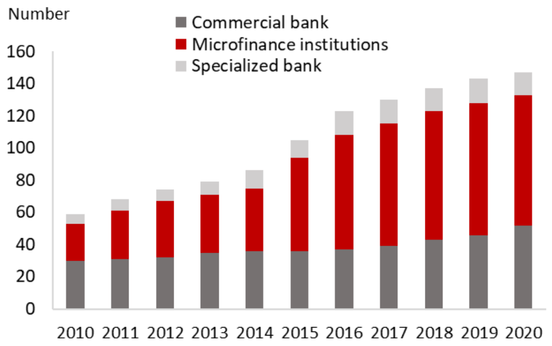
The reduction of financial burden on borrowers who are losing their income and facing difficulties in debt repayment (Circular on Loan Restructuring during COVID-19 Outbreak dated 27 March 2020). The NBC required financial institutions to work constructively with affected borrowers to allow for restructuring loans in priority sectors. These included tourism, garments, construction, and transportation. For restructured loans, financial institutions are allowed to maintain the current loan classification without additional provision requirements.

2. **Fast developing financial markets have facilitated economic growth and led to financial deepening in general.** The number of commercial banks—including branches of foreign banks—has almost doubled over the past decade, growing from 30 in 2010 to 52 in 2020 and are supervised by the NBC (Figure A1.1). The total asset size of commercial banks, driven by both the expansion of existing banks and new entrants has increased over six times, from KHR 25.3 trillion in 2010 to KHR 168.4 trillion in 2019, with the four largest banks – ACLEDA, Canadia Bank, Advanced Bank of Asia and Cambodia Public Bank – accounting for about 48 percent of total assets. In addition to commercial banks, microfinance institutions (MFIs) have also been growing fast, both in their numbers as well as in their total asset size, greatly improving financial services access in rural areas. However, MFIs' share of total assets is still relatively small at 10.1 percent of total assets held by banks and MFIs as of December

[64] This selected issue and the box was prepared by Tanyasorn Ekapirak.

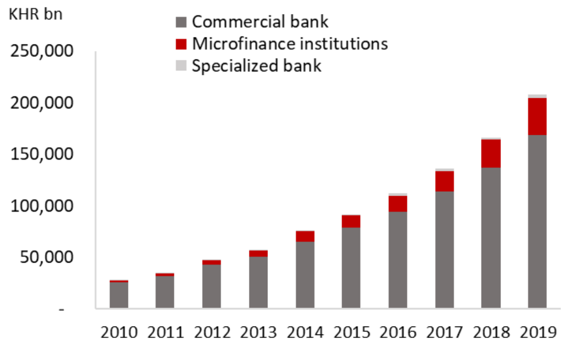
2019 (Figure A1.2). Given limited data availability on MFIs, this selected issue examines the financial sector's liquidity position using only banking sector data.

Figure A1.1. Number of Financial Institutions



Source: National Bank of Cambodia

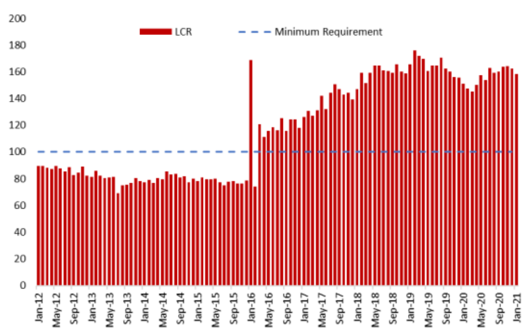
Figure A1.2. Composition of Assets by Lenders



Source: National Bank of Cambodia

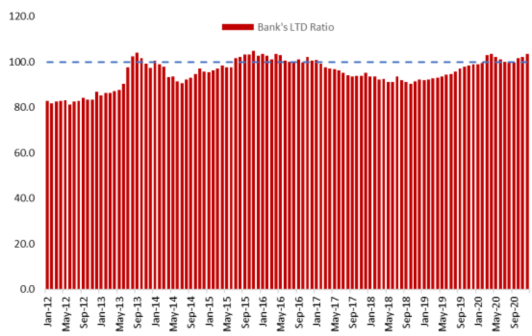
3. **Official data suggests that the overall liquidity position of the banking sector is well above the minimum requirement level, but such aggregated information may obscure liquidity risks at individual banks.** To ensure sufficient liquidity in the banking system, the NBC imposed a new regulation on the liquidity coverage ratio (LCR) in December 2015.[65] This led to an immediate response from financial institutions, and the liquidity ratio has increased substantially, reaching around 160 percent as of January 2021 (Figure A1.3). Meanwhile, after a gradual increase prior to the pandemic, the loan to deposit (LTD) ratio has been hovering at around 100 percent, implying the bulk of deposits were lent to customers (Figure A1.4). According to the aggregate balance sheet of commercial banks, customers' deposits are the main source of funds for customer loans, accounting for over 60 percent of bank liabilities (Figures A1.5 and A1.6). Although liquidity indicators and the aggregate balance sheet suggest sufficient liquidity in Cambodia's banking sector, given the high level of financial sector dollarization, large-scale simultaneous deposit withdrawals could quickly jeopardize some banks' liquidity buffers, possibly leading to a financial crisis. Therefore, we first analyze the resilience of banks' liquidity situation under various stress scenarios of a run on customers' deposit.

Figure A1.3. Banks' LCR



Source: National Bank of Cambodia

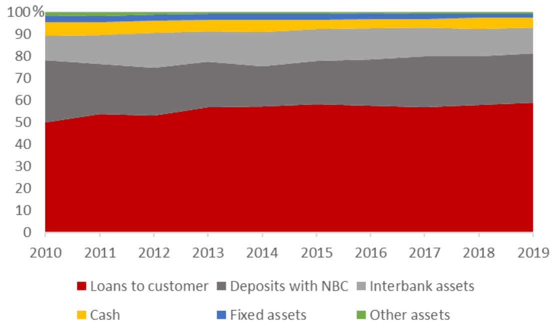
Figure A1.4. Banks' LTD Ratio



Source: National Bank of Cambodia

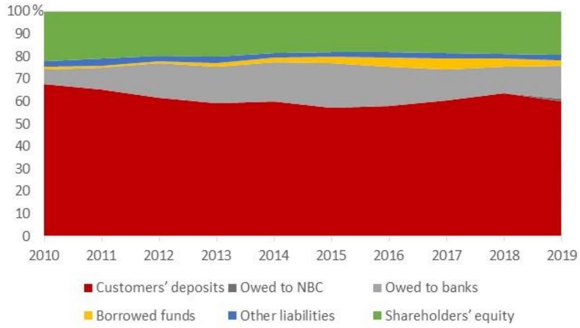
[65] At the end of December 2015, the NBC issued a Prakas to set a minimum liquidity coverage ratio (LCR) requirement for deposit-taking financial institutions, where the framework of LCR mainly follows the definitions and categorizations of BASEL III. Starting from 1 September 2016, all deposit-taking financial institutions became bound by a minimum LCR of 60 percent, which is set to increase incrementally by 10 percentage point each year, reaching 100 percent of LCR in January 2020

Figure A1.5. Commercial Banks' Assets



Notes: 1) Interbank assets includes due from banks, deposits with banks, and loans and advances to banks. 2) Other assets includes securities, claims on government, prepaid expenses, and other assets.
Source: National Bank of Cambodia

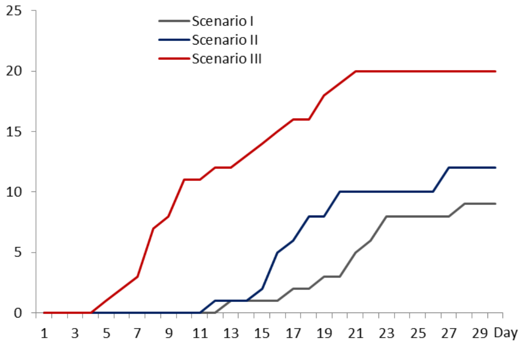
Figure A1.6. Commercial Banks' Liabilities



Notes: 1) Customers' deposits includes demand deposits, savings deposits and fixed deposits.
Source: National Bank of Cambodia

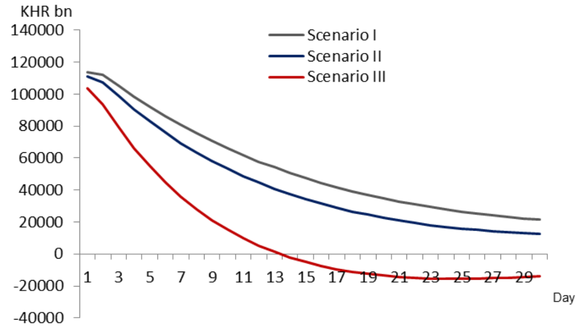
4. **A liquidity stress test is conducted to examine the sufficiency of liquidity buffers for 30-day stress scenarios with varying withdrawal rates.** For banking sector liquidity, we analyze the 30-day liquidity sufficiency by examining liquidity availability to finance net cash outflows under the stress scenario for 30 business days. Our liquidity stress test is based on a few standard assumptions about the key components affecting banks' liquidity conditions.[66] Specifically, on the asset side, we assume that up to 95 percent of liquid assets can turn into available liquidity within a day (availability rate).[67] Meanwhile, illiquid assets can turn into liquidity at 1 percent per day, which are standard assumptions in stress testing. On the liability side, with three different types of customers' deposits (demand deposits, savings deposits and fixed deposits), we set three scenarios with different withdrawal rates of either 5 percent or 10 percent.[68] Under scenario I (Baseline), all types of deposits have the same withdrawal rate of 5 percent. Scenario II (Moderate) assumes a 10 percent withdrawal rate for demand deposits, while the others still maintain 5 percent. Scenario III (Severe) hypothesizes that all types of deposits have the same withdrawal rate of 10 percent.

Figure A1.7. Number of Banks with Liquidity Shortage



Source: AMRO staff calculations

Figure A1.8. Liquidity in the Banking Sector



Source: AMRO staff calculations

[66] Generally, banks' capacity to withstand liquidity stress depends on many factors, such as the withdrawal rate of liabilities, the speed of liquidation of assets, maturity/ currency mismatch of assets and liabilities, and availability of liquidity support facilities.
[67] Liquid assets consist of cash (15 percent), deposits with the NBC (60 percent), demand deposits with banks (5 percent) and deposit with and loan and advance to banks (20 percent). We assume zero percent haircut on cash, deposits with the NBC, and demand deposits with banks. Without more detailed information on interbank lending, we assume a 25 percent haircut on deposits with and loan and advances to other banks.
[68] Considering Cambodia's high level of dollarization, we assume slightly higher withdrawal rates. According to the Bank of International Settlements' (BIS) LCR framework dated 15 December 2019, the runoff rates during the stress period of 3 percent and 10 percent are applied to stable deposits and less stable deposits, respectively, within the banking system.

5. **The stress test reveals that some small and medium banks face potential liquidity shortages under the Baseline and Moderate scenarios, while one large bank could face liquidity shortage under the Severe scenario.**[69] This liquidity stress test exercise is based on 36 commercial banks' data as of December 2019,[70] which account for about 97 percent of total assets in the banking system. The stress test results show that under both Baseline and Moderate scenarios, aggregate liquidity in the overall banking sector remains positive for 30 days (Figure A1.8 and Table A2), but some banks may face liquidity shortages during this period. Under the Baseline scenario, nine small and medium-sized commercial banks may face liquidity shortages during the 30-calendar day stress period (Figure A1.7). The first case arises on Day 13, and the number increases gradually to nine commercial banks by Day 28, accounting for about 19 percent of total assets in the banking system (Table A1). Under the Moderate scenario, with a faster withdrawal of demand deposits, the number of banks facing liquidity issues increases to 12 commercial banks by Day 27, with the first bank falling into liquidity shortage on Day 12. Under the Severe scenario, the first instance of liquidity shortage appears much earlier on Day 5, and the number rises to 20 by Day 21, with one large bank facing liquidity shortage on Day 21. These 20 banks with potential liqudity shortages comprise about 40 percent of total assets in the banking system. Under this Severe scenario, liquidity in the system will dry up by Day 14 and external liquidity injection will become necessary. The cumulative liquidity shortage peaks on Day 25 at KHR 15,100 billion. Given the vulnerability of some banks to bank runs, authorities need to ensure that these banks improve their liquidity management.

[69] Small, medium and large banks are classified by the total asset size with less than KHR 1 million; between KHR 1 and 10 million; and over KHR 10 million, respectively. This exercise is based on 36 commercial banks comprising 8 small banks, 24 medium banks and 4 large banks.

[70] By using data as of December 2019, the stress test is not able to take into account the accommodative monetary policy deployed by the NBC in response to the pandemic. With this caveat, the prospective number of days when a bank may experience liquidity shortfall should be longer than what the stress results indicate due to the injection of liquidity by the NBC at the onset of the pandemic.

Table A1. Percent of Total Banks and Percent of Total Assets

	Baseline			Moderate			Severe		
Day	Number of banks illiquid	Percent of total banks	Percent of total assets	Number of banks illiquid	Percent of total banks	Percent of total assets	Number of banks illiquid	Percent of total banks	Percent of total assets
Day 1	0	0	0	0	0	0	0	0	0
Day 2	0	0	0	0	0	0	0	0	0
Day 3	0	0	0	0	0	0	0	0	0
Day 4	0	0	0	0	0	0	0	0	0
Day 5	0	0	0	0	0	0	1	2.8	1.9
Day 6	0	0	0	0	0	0	2	5.6	5.9
Day 7	0	0	0	0	0	0	3	8.3	9.5
Day 8	0	0	0	0	0	0	7	19.4	14.2
Day 9	0	0	0	0	0	0	8	22.2	16.0
Day 10	0	0	0	0	0	0	11	30.6	19.9
Day 11	0	0	0	0	0	0	11	30.6	19.9
Day 12	0	0	0	1	2.8	1.9	12	33.3	23.3
Day 13	1	2.8	1.9	1	2.8	1.9	12	33.3	23.3
Day 14	1	2.8	1.9	1	2.8	1.9	13	36.1	25.2
Day 15	1	2.8	1.9	2	5.6	5.5	14	38.9	26.2
Day 16	1	2.8	1.9	5	13.9	10.4	15	41.7	27.0
Day 17	2	5.6	5.5	6	16.7	10.6	16	44.4	29.7
Day 18	2	5.6	5.5	8	22.2	15.7	16	44.4	29.7
Day 19	3	8.3	6.0	8	22.2	15.7	18	50.0	32.5
Day 20	3	8.3	6.0	10	27.8	22.0	19	52.8	33.3
Day 21	5	13.9	10.3	10	27.8	22.0	20	55.6	39.7
Day 22	6	16.7	11.9	10	27.8	22.0	20	55.6	39.7
Day 23	8	22.2	16.0	10	27.8	22.0	20	55.6	39.7
Day 24	8	22.2	16.0	10	27.8	22.0	20	55.6	39.7
Day 25	8	22.2	16.0	10	27.8	22.0	20	55.6	39.7
Day 26	8	22.2	16.0	10	27.8	22.0	20	55.6	39.7
Day 27	8	22.2	16.0	12	33.3	24.7	20	55.6	39.7
Day 28	9	25.0	18.6	12	33.3	24.7	20	55.6	39.7
Day 29	9	25.0	18.6	12	33.3	24.7	20	55.6	39.7
Day 30	9	25.0	18.6	12	33.3	24.7	20	55.6	39.7

Table A2. Liquidity Shortfall in System by Day 30

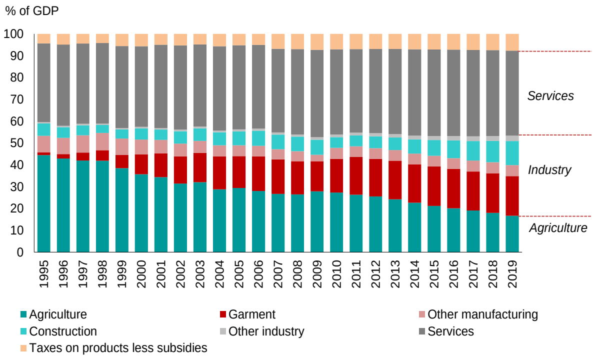
		Overall	Small	Meduim	Large
	Number of banks	36	8	24	4
Baseline	Number of bank failing the test	9	2	7	0
	Liquidity shortfall by Day 30 (KHR Billion)	N/A	N/A	N/A	N/A
	Liquidity shortfall (In % total assets)	N/A	N/A	N/A	N/A
	Liquidity shortfall (In % liquid assets)	N/A	N/A	N/A	N/A
Moderate	Number of bank failing the test	12	2	10	0
	Liquidity shortfall by Day 30 (KHR Billion)	N/A	N/A	N/A	N/A
	Liquidity shortfall (In % total assets)	N/A	N/A	N/A	N/A
	Liquidity shortfall (In % liquid assets)	N/A	N/A	N/A	N/A
Severe	Number of bank failing the test	20	4	15	1
	Liquidity shortfall by Day 30 (KHR Billion)	13,690	960	12,540	190
	Liquidity shortfall (In % total assets)	8.1	0.6	7.4	0.1
	Liquidity shortfall (In % liquid assets)	20.9	1.5	19.2	0.3

Annex 2. Cambodia's Economic Transformation and Industrial Diversification[71]

Structural transformation is an essential component of a country's economic development process, and Cambodia is no exception. This selected issue looks at how Cambodia's economy has evolved structurally, especially concerning the industry sector, while discussing structural challenges hampering the further diversification of the economy.

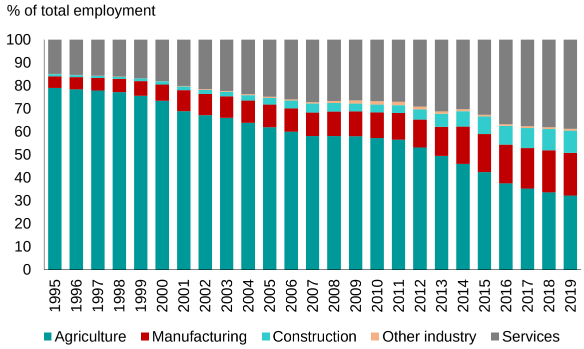
1. **Once largely agriculture-based, Cambodia has been gradually shifting towards an industrial and service economy.** The share of agriculture sector in GDP declined from 44.4 percent in 1995 to 16.7 percent in 2019, while that of the industry sector increased rapidly from 15.2 percent to 36.6 percent during the same period (Figure A2.1). Service sector's contribution to GDP remained relatively constant at about 38.4 percent during the period, with high concentration in tourism-related sectors—such as hotels and restaurants, transport and communications, and domestic trade. In tandem with such a transition of economic activity, employment share of the agriculture sector shrank from 79.0 percent of total employment in 1995 to merely 32.3 percent of total employment in 2019, whereas the industry and service sectors have seen a surge in their employment shares to 29.0 and 38.7 percent over the past two decades (Figure A2.2). It is worth noting that the employment in the services sector has increased sharply even though the value added share has not increased by much.

Figure A2.1. GDP by Sector



Source: National Institute of Statistics; AMRO staff calculations
Note: Real GDP share is used to indicate the real contribution of the sectors.

Figure A2.2. Employment by Sector

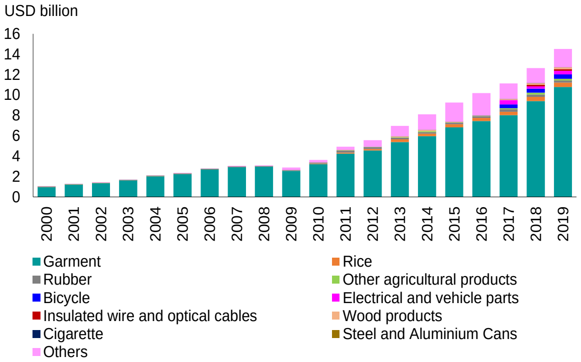


Source: ILO; AMRO staff calculations

2. **The expansion of industry sector has been dominated by garment manufacturing and construction, with only minor progress in diversification.** The garment manufacturing and construction sectors together accounted for 79.5 percent of the industry sector GDP (29.2 percent of total GDP) in 2019. Moreover, the garment manufacturing sector is one of Cambodia's biggest employers[72], and also the biggest exporter.[73] Amid the dominance of garment manufacturing, other industrial products have seen only a slight increase in their export share recently, reflecting a slow progress in diversification within the industry sector (Figure A2.3). The construction sector has also been one of the major growth drivers, but its development depends heavily on foreign investment, with growing concerns on asset prices in certain areas.[74]

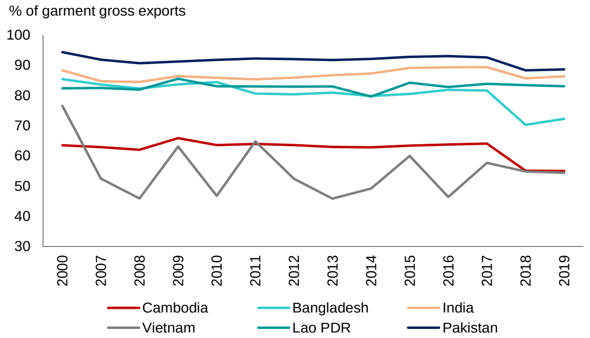
[71] This selected issues was prepared by Vanne Khut.
[72] According to Ministry of Industry, Science, Technology and Innovation, 864,386 workers (86.6 percent of total factory workers) are employed in the garment sector.
[73] According to the GDCE's administrative trade data, roughly 74.3 percent of total exports (USD10.8 billion) in 2019 are garment products, down from 91.1 percent (USD962 million) in 2000.
[74] Chinese investment is reported to account for roughly one-third of the capital investment in Cambodia's construction and real estate sector in 2018 (Elten, 2018).

Figure A2.3. Share of Exports by Product



Source: Ministry of Economy and Finance; AMRO staff calculations
Note: The administrative trade data is used because of long-time series.

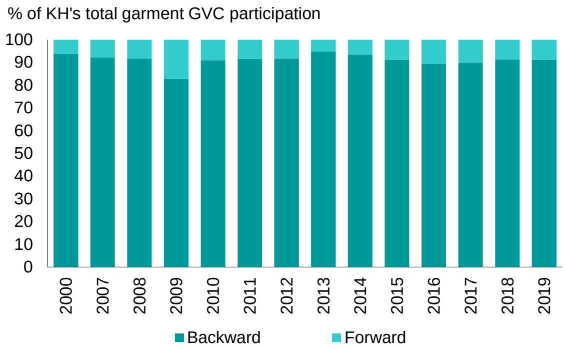
Figure A2.4. DVA Share of Garment Exports of Selected Major Competitors



Source: Asian Development Bank; AMRO staff calculations

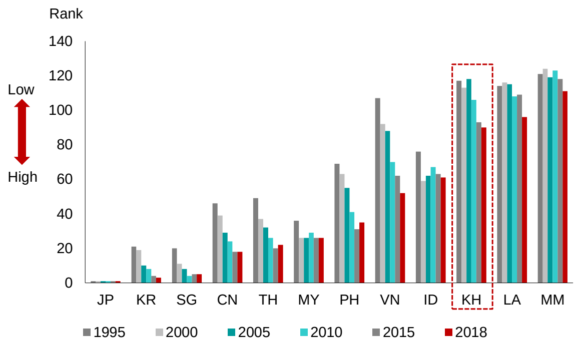
3. **Trapped in low value added garment manufacturing, backward linkages continue to be high in garment sector's global value chain (GVC) participation.** The country's domestic value added (DVA) in garment exports has been quite low relative to other garment producing competitors (Figure A2.4).[75] This reflects the low level of value-chain participation of Cambodia's garment manufacturing sector — the bulk of its garment industry remains at the processing stage of production, producing mostly low- to medium-end products.[76,77] In addition, the share of backward linkages in Cambodia's garment sector GVC participation remained high at 91.0 percent of total garment GVC participation in 2019 (Figure A2.5), implying foreign value added content of Cambodia's garment exports is high. Given insufficient domestic supporting industries, Cambodia's 1,092 garment factories nationwide[78] have to rely heavily on imported raw materials to supply its garment manufactures for exports.[79]

Figure A2.5. GVC Participation of Garment Sector



Source: Asian Development Bank; AMRO staff calculations

Figure A2.6. Economic Complexity Index



Source: Atlas of Economic Complexity, Harvard University

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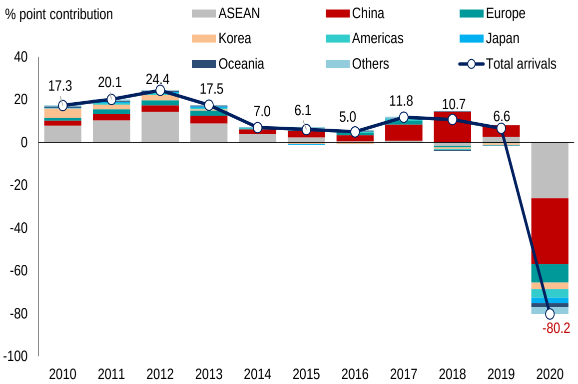
[75] Domestic value added (DVA) refers to the value added portion embedded in an economy's gross exports, which are ultimately absorbed abroad. (Wang, Wei, and Zhu, 2018) Garment sector combines Sector 4 (Textiles and textile products) and Sector 5 (Leather, leather products, and footwear) in the ADB's Multiregional Input-Output Tables.
[76] According to Duke University (2011), there are four stages of garment sector's value chain: 1) assembly/cut, make, and trim (CMT); 2) original equipment manufacturing (OEM)/Full Package/Free on Board (FOB); 3) original design manufacturing (ODM); and 4) original brand manufacturing (OBM). See AREO 2021 (Box 2.2) for additional discussion on DVA in garment GVCs.
[77] According to GMAC, about 70 percent of garment factories in Cambodia are CMT, while the remaining 30 percent are at the second stage of garment sector's value chain – FOB. For the case of Vietnam, the garment exports based on CMT account for 65 percent of its total garment exports, while 35 percent come from the more advanced stages like ODM (Nguyen 2020). According to the Ministry of Textiles of India, Bangladesh and Pakistan, are at OEM stage (Khawar et. al., n.d.).
[78] Source: Ministry of Industry, Science, Technology and Innovation.
[79] In 2019, Cambodia imported USD4.5 billion worth of fabric (22.3 percent of its total imports) and exported USD10.8 billion worth of garment products.

4. **Limited diversification could put Cambodia in a more vulnerable position to external shocks and unexpected policy changes.** Despite the country's continued policy efforts, the implementation of the Industrial Development Policy (2015–2025)[80] has been very slow and the export share of non-garment manufacturing products remains small although growing fast from a low base. In addition, Cambodia's exports largely depend on a few markets, such as EU-27 and the U.S. which absorbed nearly 60 percent of Cambodia's exports in 2019. Separately, Cambodia's trade with China has been growing rapidly, and China has also become the major source of investment and financing (AMRO 2019). With continued narrow-based industrial structure and exports, Cambodia ranks very low in the economic complexity index (ECI)[81] among countries in the region (Figure A2.6). Also, the service sector relies heavily on the tourism-related sectors, which have been supported mostly by international tourists, in particular Chinese tourists.[82]

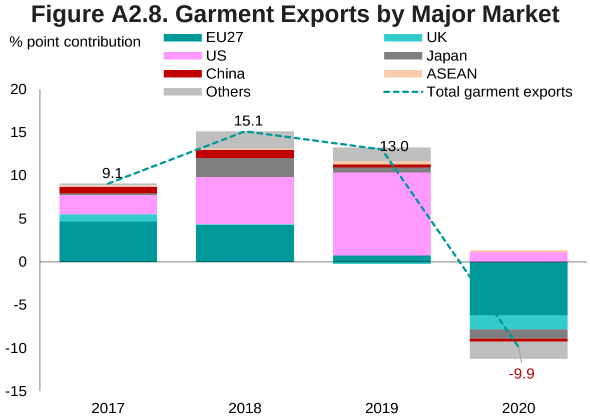
5. **This less diversified economic structure contributed to amplifying the economic fallout from the COVID-19 pandemic.** With its high reliance on few sectors and markets, Cambodia economy could not escape from the wide-ranging economic impact of the pandemic. Tighter travel and border restrictions almost entirely stalled international travel, severely affecting the tourism sector (Figure A2.7), and caused disruptions in supply chains, damaging garment manufacturing and construction sectors. Also, sudden economic slowdown in major markets, especially EU-27 and the U.S., substantially reduced demand for Cambodia's exports (Figure A2.8). Undeniably, this protracted pandemic situation around the globe and the prospect for uneven economic recovery with high downside risk, have put the Cambodian economy at great risk, with negative implications on both growth and employment of key sectors.

Figure A2.7. International Tourist Arrivals



Source: Ministry of Tourism; AMRO staff calculations

Figure A2.8. Garment Exports by Major Market



Source: Ministry of Economy and Finance; AMRO staff calculations

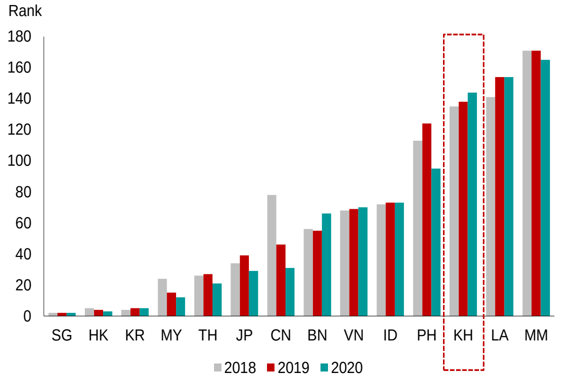
6. **Diversifying the economic structure and upgrading the existing industries will help strengthen the economy's resilience and enhance long-term growth potential.** Existing literature generally supports the positive contribution of economic diversification and export diversification to the economic performance as well as growth volatility, especially in low-

[80] IDP is the policy that aims to diversify the economy and transform its industrial structure – from a labor-intensive industry to a skill-driven industry by 2025.
[81] The Economic Complexity Index provides a ranking of countries based on the diversity and complexity of their export basket in terms of both export products and markets.
[82] Tourist arrivals from ASEAN+3 economies accounted for 76.5 percent of total tourist arrivals in Cambodia in 2019, followed by Europe 12.0 percent, and Americas 5.4 percent.

income countries (LICs).[83] While continuing diversification efforts, Cambodia also needs to promote the upgrading of the existing industries so that their value-chain participation becomes more diversified and sophisticated, helping them move up the technology value chain.

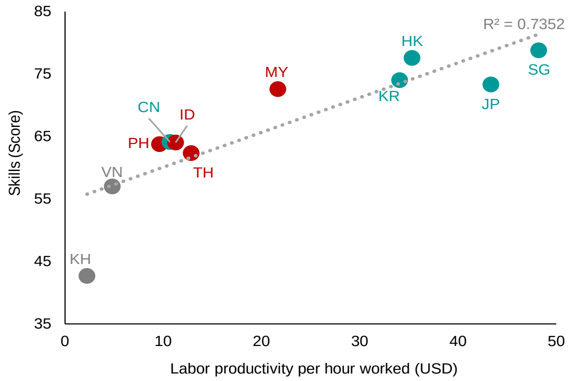
7. Long-standing structural challenges have hindered the country's ability to attract quality investments in other sectors. Given its low financing capacity, foreign direct investment has been playing a key role in Cambodia's industrial transformation. However, structural constraints in the economy, such as the lack of skilled labor, low labor productivity, insufficient infrastructure, and weak institutional environment, make Cambodia less attractive to high quality investments in strategic sectors.[84] Despite continued policy initiatives to address these constraints in the past, Cambodia continues to lag far behind many other economies in the region, as evidenced by its low ranking in Doing Business 2020 — third lowest among ASEAN+3 member economies, or 144th among 190 economies (Figure A2.9). In particular, insufficient supply of reliable infrastructure tends to push up non-labor production costs, such as logistics and electricity. Meanwhile, minimum wage is already high compared to peers, notwithstanding relatively low labor productivity (Figures A2.10 and A2.11). In addition, institutional environment and governance are relatively weak, increasing business uncertainties for potential investors (Figure A2.12).

Figure A2.9. ASEAN+3: Doing Business Ranking



Source: World Bank

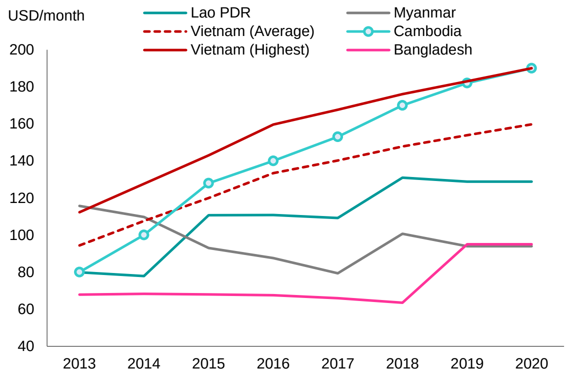
Figure A2.10. ASEAN+3: Productivity Per Hour Worked versus Skills, 2019



Source: University of Groningen; Our World in Data; and World Economic Forum
Note: Labor productivity per hour is measured as GDP per hour of work. GDP is adjusted for price differences between economies (PPP adjustment) and for price changes over time (inflation). Labor productivity per hour data are not available for Brunei Darussalam, Lao PDR, and Myanmar.

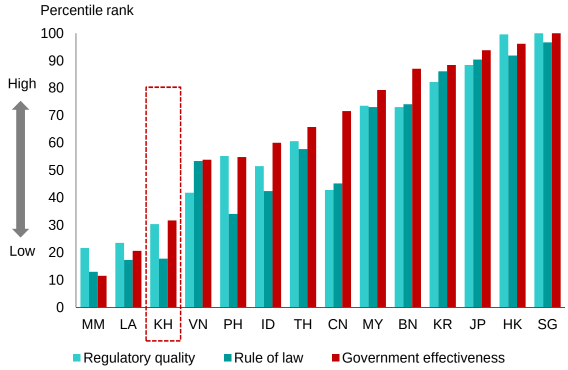
[83] Papageorgiou and Spatafora (2012) find that higher diversification spurts (rapid, sustained, significant spells of diversification) could help reduce volatility of output growth by 30 percent for LICs. The IMF (2014) estimates that one standard deviation increase in LICs' export product diversification and output diversification can raise their growth rate by roughly 0.8 percentage points and 1.4 percentage points, respectively.
[84] According to AMRO (2021), key considerations for investment relocation are economic factors, including labor costs, infrastructure quality, skills, and market size, among others.

Figure A2.11. Minimum Wages



Source: National authorities; various media

Figure A2.12. ASEAN+3: Selected Governance Indicators, 2019



Source: World Bank

Note: Percentile rank indicates an economy's rank among all economies covered by the aggregate indicator, with 0 corresponding to the lowest rank, and 100 the highest rank. BN = Brunei Darussalam; CN = China; HK = Hong Kong; ID = Indonesia; JP = Japan; KH = Cambodia; KR = Korea; LA = Lao PDR; MY = Malaysia; MM = Myanmar; PH = Philippines; SG = Singapore; TH = Thailand; VN = Vietnam.

8. **Accelerating structural reforms to properly address structural constraints is critical to speed up the diversification and strengthen growth potential going forward.** Addressing infrastructure gaps and providing reliable public services are essential to create an enabling environment, strengthen competitiveness and attract quality investments. Quality infrastructure — by lowering the general business costs — enables profitable investments in more diverse areas and sectors. This helps diversify economic structure by attracting new investments in more diverse areas, and upgrade existing investments. However, other binding structural constraints also need to be properly addressed for improving infrastructure to take full effect. For example, in the face of accelerated technological changes caused by the pandemic, not only appropriate infrastructure but also sufficient supply of technicians are needed to further embrace digital technologies with sufficient private sector participation. Furthermore, upgrading the overall business and institutional environment is critical in attracting quality FDIs to leverage on improved infrastructure, and reducing institutional uncertainties that may adversely affect investor confidence.

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