AMRO Annual Consultation Report

Cambodia - 2018

The ASEAN+3 Macroeconomic Research Office (AMRO)

November 2018

Acknowledgements

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

2. This Report is drafted on the basis of the Annual Consultation Visit of AMRO to Cambodia from 3 – 12 September 2018 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr. Seung Hyun Hong, Group Head and Lead Specialist. Members include Dr. Abdurohman (Specialist), Dr. Jerry Xianguo Huang (Economist), Dr. Tanyasorn Ekapirak (Researcher), Ms. Vanne Khut (Researcher) and Mr. Sophak Duong (Associate). AMRO Director Dr. Junhong Chang and Chief Economist Dr. Hoe Ee Khor also participated in key policy meetings with the authorities. This AMRO Annual Consultation Report on Cambodia for 2018 was peer reviewed by Dr. Sumio Ishikawa (Group Head and Lead Economist) and Mr Paolo Hernando (Senior Economist) and Ms. Wanwisa Vorranikulkij (Specialist); and approved by Dr. Hoe Ee Khor, AMRO Chief Economist.

3. The analysis in this Report is based on information available up to 2 November 2018.

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

5. No part of this material may be disclosed unless so approved under the AMRO Agreement.

6. 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.

Table of Contents

Executive Summary **4**
A. Recent Developments and Outlook **6**
A. 1. Real Sector Developments and Outlook 6
A. 2. External Sector and the Balance of Payments 8
A. 3. Banking and Financial Sector 9
A. 4. Fiscal Sector 10
B. Risks, Vulnerabilities and Challenges **13**
C. Policy Discussions **16**
Appendices **21**
1. Selected Figures for Major Economic Indicators 21
2. Selected Economic Indicators for Cambodia 25
3. Balance of Payments 26
4. Statement of Government Operations 27
5. Data Adequacy for Surveillance Purposes: A Preliminary Assessment 28
Annexes: Selected Issues **29**
1. Distributional Impact of Fiscal Policy in Cambodia 29
2. Impacts of the Interest Rate Cap on Cambodia's MFIs 34
3. Cambodia's Preferential Trade Schemes: Recent Developments and Risks 39
4. The Development of Tourism in Cambodia 44

Executive Summary

1. **Cambodia's economy continued its robust growth with a relatively stable inflation rate.** The economy grew steadily at 7.0 percent in 2017, at par with the previous two years. Moderation in the garment manufacturing sector was offset by robust construction activities, solid growth in tourist arrivals and better agriculture production. Helped by stronger export growth, robust tourist arrivals and buoyant domestic demand - in particular government consumption and investment - economic growth is expected to accelerate to 7.2 percent in 2018. Meanwhile, inflation has remained low at 2.9 percent in 2017 and is projected to edge down to 2.6 percent in 2018, on account of better supply conditions despite pressures from energy prices.

2. **The overall external position continues to strengthen, benefiting from sustained FDI inflows**. Although the current account deficit remains sizable, it has been more than offset by the surplus in the capital and financial account on the back of strong FDI inflows. As a result, the overall balance of payments has continued to be in surplus, leading to a further build-up in foreign reserves. Gross international reserves are estimated to be around USD10 billion by end-2018, sufficient to cover about six months of goods and services imports.

3. **Financial sector indicators have remained sound amid moderating credit growth.** Amidst the implementation of stricter prudential regulations, including higher minimum capital requirements and liquidity coverage ratio, banks' credit growth to the private sector continued to moderate from 19.8 percent in 2016 to 18.5 percent in 2017. The loan-to-deposit ratio has declined as credit growth has decelerated while deposit growth has trended up. The financial sector remains well-buffered as the CARs in both commercial banks and MFIs have continued to be above the regulatory minimums.

4. **The fiscal deficit has widened despite strong revenue collection.** The Revenue Mobilization Strategy 2014-2018 has resulted in a strong improvement in government revenue collection, driven mainly by enhanced tax administration and audits. However, government spending has increased even faster, due to the government's expansionary policy to support government priority policies and enhance public services. As a result, the overall budget deficit widened from 2.4 percent of GDP in 2015 to 2.7 percent in 2017, and is projected to widen further to 4.4 percent of GDP in 2018 on account of rising public investment and public sector wages.

5. **The major downside risk stems from the rising labor cost.** The minimum wages in the garment sector have gone up from USD80 per month in 2013 to USD170 in 2018, and scheduled to increase again to USD182 in 2019. Together with strengthening USD, this has significantly affected the garment industry's labor-cost competitiveness while other production costs such as logistics costs remain relatively high.

6. **Several external risks related to recent developments are also worth noting.** Given its high reliance on the E.U. market under the Everything But Arms (EBA) preferential trade scheme, a suspension of the EBA scheme, which is under consideration, could substantially weaken its export competitiveness in the E.U. market. Furthermore, implementation of the E.U. - Vietnam FTA, once ratified, could further undermine Cambodia's share in the E.U. market. Another external risk is the further escalation of the U.S. – China

trade war, which could weaken growth in these two economies with spillovers to the rest of the world, which will slow Cambodia's export growth.

7. **Risks to financial sector stability come from several fronts.** While overall bank loan growth has continued to slow down, credit to real estate and construction sectors remains strong, which could heighten credit risks associated with a major correction in those sectors. In addition, the rapid expansion of MFIs has significantly increased their role in the financial sector, while they are subject to less stringent regulations. Overall credit growth slowdown, if too rapid, may create distress in the financial sector. The NPL of the commercial banks has been rising while profitability has been declining in tandem with continued loan growth slowdown.

8. **Efforts to maintain external competitiveness and to diversify the economy should be continued in order to sustain high growth potential in the medium term.** While wage increases should be in line with underlying productivity growth, offsetting past wage hikes requires Cambodia to continue improving its competitiveness across other dimensions including trade facilitation, upgrading labor quality and logistics, and institutional improvement. Given a relatively narrow growth base, continued efforts to diversify growth are also essential, and the tourism-related service sector shows great potential. Cambodia's less diversified tourism products and less developed infrastructure (both physical and institutional) require enhanced policy support for the sector to realize its potential.

9. **A better management of public resources to address priority needs is critical.** Improving infrastructure and human resources is essential to enhance overall competitiveness and to promote economic diversification. In this regard, reprioritizing fiscal expenditure is critical, especially to address the infrastructure gap and to improve human capital, which will facilitate structural reforms to enhance competitiveness and resilience. The rapid growth in current expenditure needs to be reined in by keeping the increase in the total public wage bill on a sustainable path, which can be supported by the PFM Reform Programs. Continued efforts to strengthen revenue collection and fiscal prudence will help to build fiscal buffer both for precautionary purposes and for supporting growth.

10. **Continued vigilance over the financial system is needed to maintain financial stability.** Further efforts to enhance the prudential policies are important to effectively manage financial stability risks, including upgrading the regulations on MDIs to be broadly in line with those on commercial banks. Supervisory capacity should also be strengthened further to ensure proper and timely risk assessment and appropriate policy response.

11. **The continued buildup of foreign reserves is recommended.** Despite significant improvement in its foreign reserve buffer, Cambodia's economy remains relatively vulnerable to external shocks, with its narrow export base and high dependence on external funding for investment. Therefore, the authorities should continue to build up foreign reserves as a buffer against external and domestic liquidity shocks, as the USD remains the dominant currency used for domestic transactions.

A. Recent Developments and Outlook

A. 1. Real Sector Developments and Outlook

1. **Cambodia's economy continued its robust growth in 2017 and growth is expected to strengthen in 2018.** Economic growth has remained stable compared to the previous two years, at 7.0 percent. A moderation in the garment manufacturing sector was offset by robust construction activities, solid growth in tourist arrivals and higher agriculture production. Helped with stronger export growth, robust tourist arrivals and buoyant domestic demand, in particular government consumption and investment, the growth is expected to accelerate in 2018.

2. **While the garment manufacturing sector moderated, growth has been bolstered by robust activity in the construction sector.** Garment manufacturing grew by 5.8 percent in 2017, slower than the 6.7 percent in 2016, as garment exports continued to slow down. The construction sector, however, continued to show strong growth, at 18 percent in 2017. Although the rate of growth was slightly slower than in the previous year, it provided strong growth support.

3. **The agriculture sector strengthened in 2017 on the back of better weather conditions and a larger cultivation area**. The agriculture sector expanded by 1.7 percent in 2017 – the fastest pace since 2013 – led mainly by rising production in crops on account of favorable weather, a larger area of cultivation and higher international prices, particularly rice. As the largest contributor to the sector (around 58 percent), crops production grew by 2.2 percent in 2017 from 2.0 percent in 2016.

4. **Tourism-related services picked up on account of a strong rebound in tourist arrivals.** (see Selected Issue 4) Hotels and restaurants posted a strong 5.9 percent growth rate in 2017, surging from 2.6 percent in 2016, as tourist arrivals rose sharply.[1] The services sector as a whole, which contributed around 40 percent of total GDP, grew by 7.0 percent in 2017, slightly higher than the 6.8 percent growth in 2016. As of August 2018, tourist arrivals continued to increase, reaching nearly 4 million or an increase of 11.7 percent – this was driven by an increase in the number of Chinese tourists by 72.2 percent, contributing around 32 percent of total tourist arrivals.

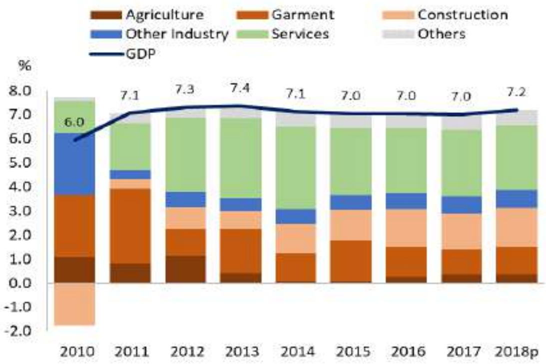
5. **Growth momentum has remained strong in 2018.** After a few years of gradual moderation, merchandise exports rebounded strongly at 13.4 percent in the first half of 2018, supported mainly by a strong 16.1 percent growth in garment exports, especially to the U.S. market. Meanwhile, tourist arrivals continued to grow at a fast pace, led by the large influx of Chinese tourist arrivals with more direct flights between the two countries. With an increase in cultivated area in 2018, agriculture production is also expected to continue increasing.[2] In addition, greater government spending on account of higher wages, election-related

[1] Tourist arrivals surged to a record high of 5.6 million in 2017, an increase of 11.8 percent from the previous year, driven mainly by tourist arrivals from China, which grew by 45.9 percent.

[2] According to the Ministry of Agriculture, Fisheries and Forestry, the cultivated area of paddy has continued to increase. As of April 2018, the cultivated area of paddy and industrial crops was around 3.2 million hectares, larger than the 3.1 million hectares in April 2017.

expenses, and higher public investment are expected to provide a boost to growth in 2018. GDP growth in 2018 is projected to pick up to 7.2 percent (Figure 1) and is expected to remain strong in 2019 (Appendix 1), albeit slightly lower.

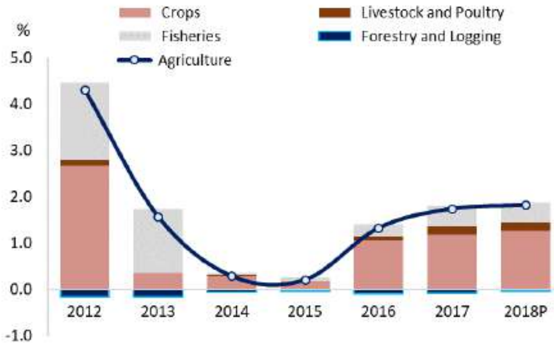
Figure 1. GDP Growth Contribution



Note: Garment and Construction are sub-categories in the Industry Sector in the Cambodia's National Account. 2018P is based on AMRO staff projection.

Source: NIS, AMRO Staff projection

Figure 2. Agriculture growth Contribution

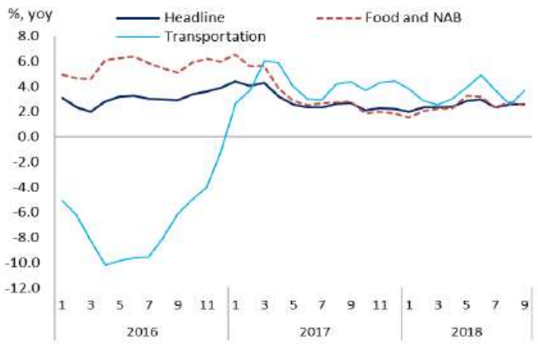


Note: 2018P is based on AMRO staff projection

Source: NIS, AMRO Staff projection

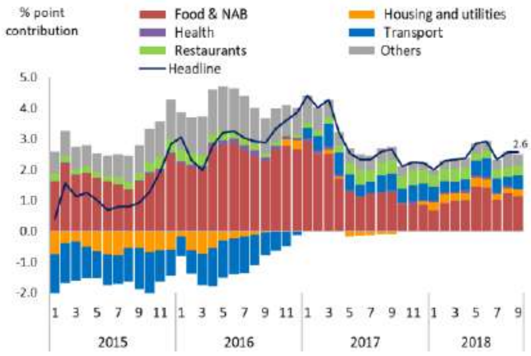
6. **Headline inflation has remained relatively subdued despite pressures from energy prices**. Headline inflation averaged 2.9 percent in 2017, slightly lower than the 3.0 percent inflation recorded in 2016. Upward pressures on energy prices and transportation costs were partially offset by lower food price inflation with better supply conditions. The first half of 2018 saw a gradual upward trend in inflation with rising transportation costs while administrative measures by the government moderated the upward pressures from the rising energy prices.[3] As of September 2018, inflation has averaged 2.5 percent, lower than the 3.1 percent in the same period last year. As pressures on inflation are likely to ease toward the end of the year harvest season (November – January), headline inflation is projected to edge down to 2.6 percent in 2018 before inching up slightly in 2019 with stronger domestic demand.

Figure 3. Headline, Food and Transportation Inflation



Source: NIS, AMRO Staff estimations

Figure 4. CPI Inflation by Components



Source: NIS, AMRO Staff estimations

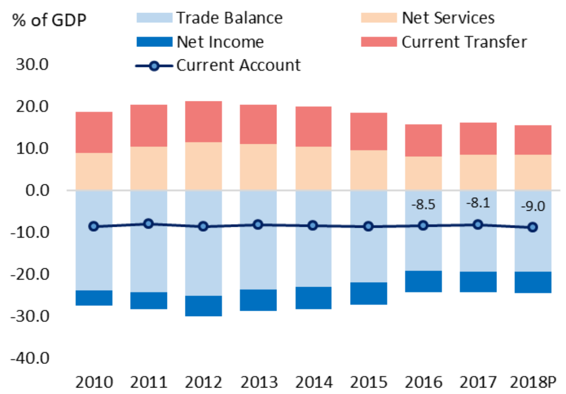
[3] Starting 1 July 2018, the government has lowered the special tax rate on gasoline from 35 percent to 5.5 percent, on diesel from 15 percent to 5.5 percent, and on kerosene from 15 percent to 5 percent.

A. 2. External Sector and the Balance of Payments

7. **The current account deficit has remained sizeable with a slight uptick in 2018 owing to increasing imports**. In 2017, the trade deficit widened as exports decelerated while consumption-related imports saw strong growth. However, the services account improved on the back of a strong rebound in tourist arrivals, narrowing the current account deficit to 8.1 percent of GDP in 2017 from 8.5 percent in 2016. Increase in the current transfers (grants and remittances) also contributed to the improvement of the current account in 2017. In the first half of 2018, exports rebounded strongly with surging garment exports. Imports, however, increased faster due to higher import contents required in garment manufacturing, strong construction activities, and stronger domestic demand. As a result, the current account deficit is projected to widen to 9.0 percent of GDP in 2018.

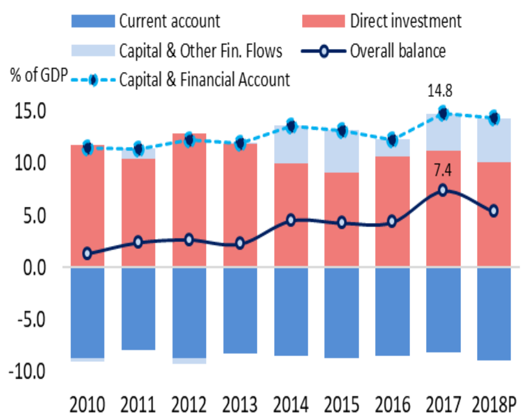
8. **The large surplus in the capital and financial account has continued on the back of strong FDI inflows.** The capital and financial account surplus rose from 12.3 percent of GDP in 2016 to 15.1 percent of GDP in 2017 supported by strong FDI inflows. The regulation on raising the minimum capital requirements led to a sharp increase in capital inflows to the financial sector by 47.4 percent in 2017 compared to the previous years. FDI inflows to other sectors, in particular the construction and real estate sector, also remained relatively strong. The inflows to financial sector are likely to moderate in 2018 as the effect of the new regulation on minimum capital requirement is fading, while FDI inflows to other sector are expected to stabilize.

Figure 5. Current Account Balance



Source: NBC, AMRO Staff estimations

Figure 6. Balance of Payments



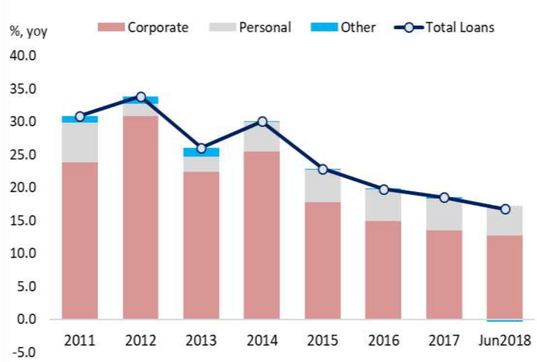
Source: NBC, AMRO Staff estimations

9. **Overall, the external position continues to strengthen.** The current account deficit has been more than covered by solid FDI inflows and the overall balance of payments has continued to be in surplus, leading to a further build-up of foreign reserves. Gross international reserves increased from USD 6.7 billion in 2016 to USD 8.8 billion in 2017, and are estimated to be more than USD10 billion by end-2018, sufficient to cover about six months of goods and services imports.

A. 3. Banking and Financial Sector

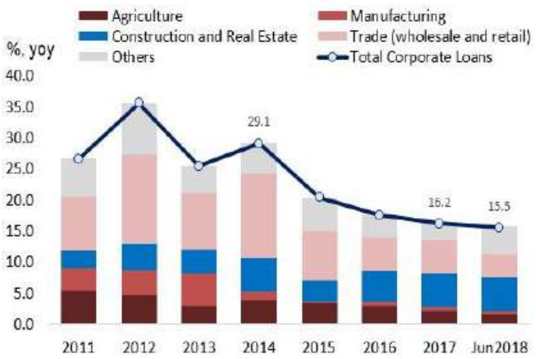
10. **Credit growth to the private sector has continued to moderate.** Credit growth to the private sector extended by commercial banks continued to decelerate from 19.8 percent in 2016 to 18.5 percent in 2017 and has further slowed to 16.7 percent as of June 2018.[4] The deceleration was mainly due to a slowdown in corporate loan growth, accounting for more than 80 percent of total outstanding loans, while personal loan growth has been relatively stable over the past few years. Meanwhile, MFIs loan growth has remained relatively strong at 35.3 percent in 2017 and 30.7 percent as of June 2018, despite the tightening of several prudential regulations, such as minimum capital requirement and liquidity coverage ratio, and the interest rate cap policy. (see Selected Issue 2)

Figure 7. Credit Growth to Private Sector



Source: NBC, AMRO Staff estimations

Figure 8. Credit Growth to Corporation by Sectors



Source: NBC, AMRO Staff estimations

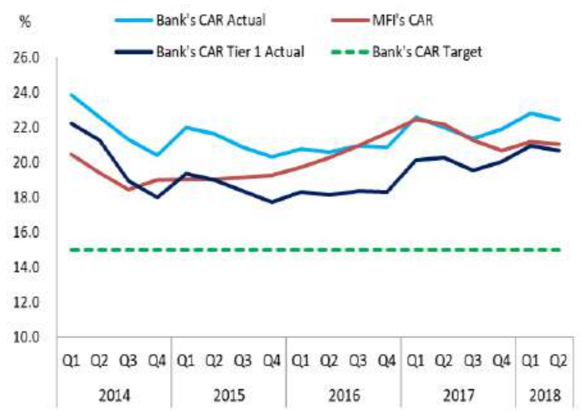
11. **Although credit growth to the corporate sector has been moderating, loans to construction and real estate have been growing faster.** Credit growth to the corporate sector continued to decline to 17.5 percent in 2016, and down further to 16.2 percent in 2017. While credit growth to the trade, manufacturing and agriculture sectors continued to slow down, loans to the construction and real estate sector have been expanding at a rapid pace, averaging 33 percent over the past five years and has become a cause for concern as a sudden sharp correction in the real estate market could adversely affect the financial sector stability. As of June 2018, credit growth to the corporate sector recorded a further slowdown to 15.5 percent (yoy), with construction sector loan growth also moderating to 28.8 percent.

12. **The loan to deposit (LTD) ratio has decreased as loan growth decelerated while deposit growth increased.** Bank deposits grew at 25.1 percent in 2017, up from 22.1 percent in 2016. Amid decelerating credit growth, expansion in bank deposits has lowered the LTD ratio in the banking sector to 95 percent in 2017 from 101 percent in 2016. In the first half of 2018, while bank deposit growth saw a slight slowdown, bank loan growth moderated even faster, resulting in a further decline in the LTD ratio. As of June 2018, the bank LTD ratio stood at 91 percent.

[4] In 2017, commercial bank loans accounted for more than 90 percent of total loans in Cambodia.

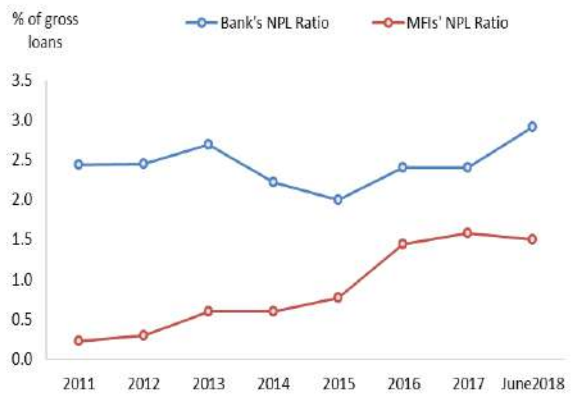
13. **Overall financial sector indicators remained relatively sound, despite a recent uptick in the NPL ratio.** The capital adequacy ratio (CAR), both in commercial banks and MFIs, is well above the minimum requirement level. The regulations to increase minimum capital requirement has led to the recent upward trend in CAR. As of June 2018, CAR of the commercial banks and MFIs stood at 22.5 percent and 21.1 percent, respectively, slightly higher than 21.9 percent and 20.7 percent as of end 2017. While loan quality has remained relatively good, the NPL ratio has been rising, especially at commercial banks (Figure 10). Meanwhile, the interest rate cap policy seems to have reduced profitability in the financial sector with the decreasing trend of interest margins to gross income ratios as lending rates decline.

Figure 9. Banks and MFIs Capital Adequacy



Source: NBC, AMRO Staff calculation

Figure 10. Banks and MFIs NPL



Source: NBC, AMRO Staff calculation

14. **Financial sector development in Cambodia has continued to progress.** The increasing adoption of IT has facilitated the further development of the financial sector in Cambodia.[5] The banking sector has been expanding rapidly and has continued to attract FDI inflows, which have also helped the growth of the insurance industry. The capital market has been growing slowly,[6] and the first corporate bond issuance is scheduled in late 2018,[7] which is among the long-term development goals of Cambodia's Financial Sector Development Strategy 2011 – 2020.

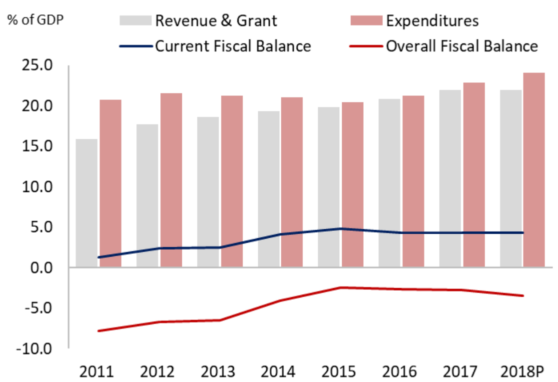
A. 4. Fiscal Sector

15. **Despite strong revenue collection, budget pressure has increased.** The revenue Mobilization Strategy (RMS) 2014-2018 led to a substantial increase in government revenue

[5] For example, a mobile trading platform has also been made available to provide investors in the capital market with a more handy and easy transaction platform using smart-phones. As of end 2017, there are 39 commercial banks, 15 specialized banks, 7 representative offices of foreign banks and 76 MFIs including MDIs. (Add insurance company numbers here) The general premium grew by 16 percent per annum on average during 2012 – 2017.
[6] Five companies have been listed since the CSX launch in 2010 with the Sihanoukville Autonomous Port the latest one. According to the CSX website, PESTECH Cambodia Limited has got in-principle approval for an IPO from SECC and will list soon.
[7] Hattha Kaksekar Limited, which is an MFI, and the IFC, a World Bank lending arm, announced proposal for corporate bonds in Cambodia amounting to USD20 million.

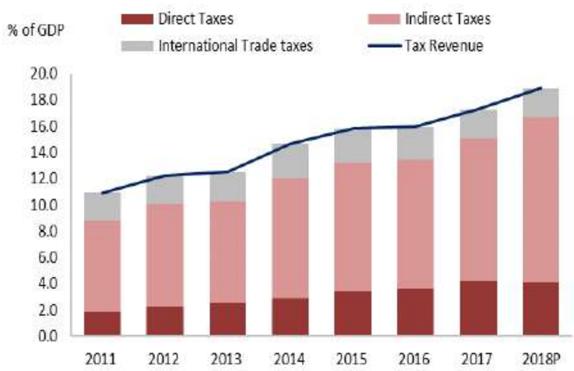
collection, driven mainly by an improvement in tax administration and compliance. Total government revenue (excluding grants) increased from 18.0 percent in 2015 to 20.1 percent of GDP in 2017. On the spending side, however, the authorities' decision to raise public sector wages has led to faster spending from 20.4 percent of GDP in 2015 to 22.8 percent in 2017[8]. As a result, the overall budget deficit has widened from 2.4 percent in 2015 to 2.7 percent of GDP in 2017, and expected to widen further to 3.6 percent of GDP in 2018 with increasing public spending related to the elections, rising public sector salaries and public investment. Nevertheless, the government has continued to maintain current budget surplus, which is expected to be above 4.0 percent of GDP in 2018. From 2019 onward, while the increase in public salaries is expected to slow down as the base salary increase ended in 2018, spending needs for development and infrastructure are likely to rise.

Figure 11. Government Budget Position



Note: 2018P refers to AMRO Staff projection.
Source: MEF, AMRO Staff estimations

Figure 12. Revenue Collection



Note: 2018P refers to AMRO Staff projection.
Source: MEF, AMRO Staff estimations

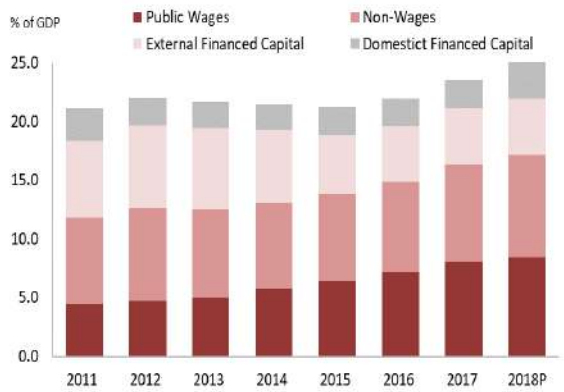
16. **The sustained increase in tax revenue collection has supported the improving revenue condition.** The implementation of the Revenue Mobilization Strategy (RMS) 2014 – 2018, focusing on improvement in tax administration and compliance, successfully increased tax revenue collection from 15.8 percent of GDP in 2015 to 17.3 percent of GDP in 2017. Between 2015 and 2017, revenue collection always exceeds its target in the Budget Law. In addition, the sustained increase in tax collection has been broad-based, with an increase in both direct and indirect taxes. Indirect tax (VAT and excise) collection increased sharply, averaging around 18 percent annually during the past three years, resulting in a substantial gain of 1.3 percentage points of GDP from 8.4 percent in 2015 to 9.7 percent of GDP in 2017. Similarly, direct tax (salary tax, corporate income tax, and land and property tax) rose from 3.4 percent of GDP in 2015 to 4.2 percent in 2017.

[8] In late 2014, the government pledged to raise the minimum wage of government employees to USD250 per month by 2018 from about USD100 per month in 2014.

17. **Current spending has been rising rapidly, boosted mainly by rising public sector wages.** The government decision to raise public sector wages[9] to at least 1 million riels a month by 2018 has led to a rapid increase in the wage bill. In nominal terms, public sector wages grew by 21.0 percent annually, on average, during the 2015 – 2017 period. Such a rapid increase in the wage bill was mainly driven by the increase in unit wages, as the total number of government employees only grew by 2.4 percent per annum, on average. As a consequence, current spending, which accounts for around two-third of total government spending, rose from 13.0 percent of GDP in 2015 to 15.7 percent in 2017 (Figure 13). The faster growth in current spending has lowered the current budget surplus, constraining the authorities' efforts to build up government deposits that can be used as fiscal buffer ors for financing public investment projects.

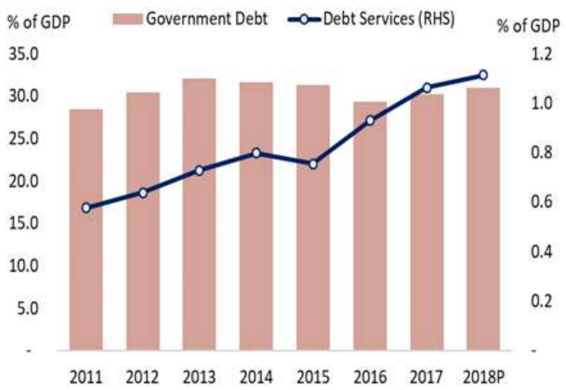
18. **The gradual decline of the external funding and the shrinking current surplus have constrained public investment.** Capital spending has been on a downward trend during 2014 – 2017, declining from 8.4 percent of GDP in 2014 to 7.2 percent of GDP in 2017, mainly due to shrinking external funding. External funding, which accounts for around 65 percent of the total funding for public investment projects, has declined steadily from 6.3 percent of GDP in 2014 to 4.7 percent of GDP in 2017. During the same period, domestic funding was relatively stable, averaging around 2.3 percent of GDP. The government, however, planned to scale domestic funding up to 3.2 percent of GDP in the 2018 budget so that total capital spending in 2018 reaches around 8.0 percent of GDP. If this materializes, it will be the first time it exceeds the level set out by the National Strategic Development Plan (NSDP).[10]

Figure 13. Government Spending Composition



Note: 2018P refers to AMRO staff projection
Source: MEF, AMRO Staff estimations

Figure 14. Government Debt



Note: 2018P refers to AMRO staff projection
Source: MEF, AMRO Staff estimations

[9] The increase of public sector wages includes both basic salary and functional allowances as an integral part of public administrative reform. This is expected to enhance the living standards of government officials leading to better quality, scope, and accessibility of public service as well as bolstering competitiveness and growth.

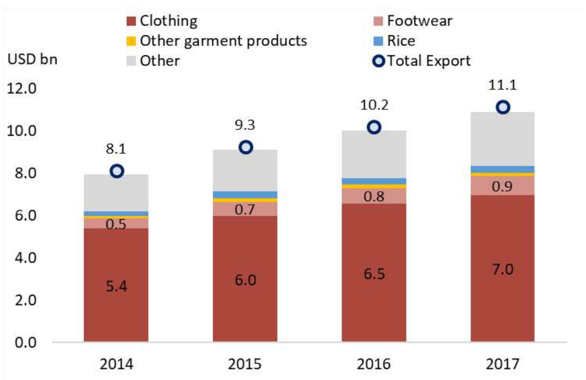
[10] The NSDP 2014 – 2018 set out the target level of public investment to GDP at 7.3 percent in 2014 and 74 percent in 2015 onward.

19. **Government debt is expected to edge up slightly with the widening budget deficit.** As the budget deficit is expected to widen, the public debt level is projected to rise from 30.2 percent of GDP in 2017 to 31.5 percent of GDP in 2018. Although the public debt to GDP ratio has been increasing, public debt is mostly in the form of concessional external loans. Therefore, debt services (principal and interest payments) burden, although increasing, remains relatively low, estimated at only around 1.1 percent of GDP in 2018 (Figure 14).

B. Risks, Vulnerabilities and Challenges

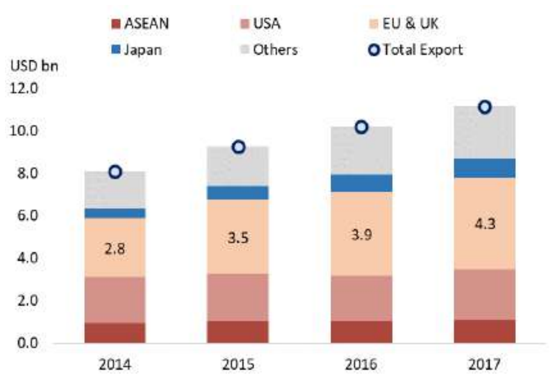
20. **Given its high reliance on the E.U. market, a sudden change in the E.U.'s trade policy towards Cambodia could affect significantly Cambodia's export.** The increasing share of exports to the E.U. area, especially garments and footwear exports, can be attributed in part to the preferential treatment given Cambodian products under the Everything But Arms (EBA) agreement. (see Selected Issue 3 and Box A3) Cambodia's total merchandise exports in 2017 stood at about USD11.1 billion, with the E.U. and U.K. combined accounting for around USD4.3 billion, or nearly about 40 percent of total merchandise exports (Figure 16). Given the recent E.U.'s concern on recent political developments, Cambodia could lose its EBA status, which could lead to a sharp fall in its exports to the E.U. In addition, the Vietnam – E.U. FTA could further undermine Cambodia's exports once it comes into effect.

Figure 15. Export Composition



Source: GD Custom

Figure 16. Export by Destination

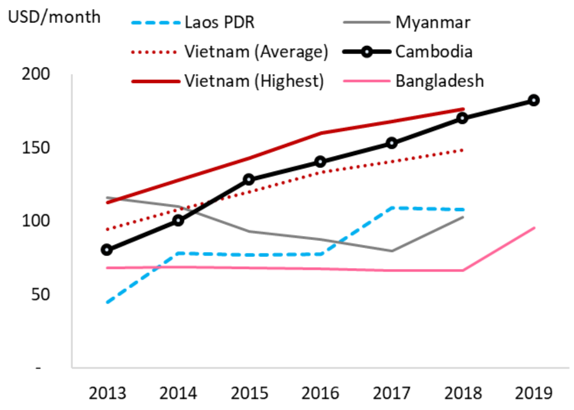


Source: GD Custom

21. **A stronger U.S. dollar, combined with continued minimum wage increases, could erode Cambodia's external competitiveness.** Rapidly increasing minimum wages have been weakening the cost competitiveness of Cambodia's labor-intensive garment industry, while non-labor production costs has remained relatively high. The monthly minimum wage in the garment sector has increased from USD80 in 2013 to USD170 in 2018, and an additional increase to USD182 is scheduled in 2019 - growth that is faster than that seen in its neighboring economies (Figure 17). In addition, owing to the high level of dollarization, Cambodian external competitiveness is adversely affected by U.S. dollar appreciation, which

could strengthen further. Figure 18 below shows that export growth has decelerated amidst an appreciating U.S. dollar.[11]

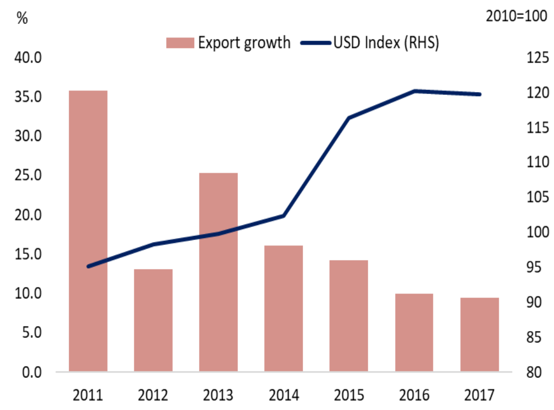
Figure 17. Minimum Wages in Garment Industry



Note: The minimum wage is set on a daily basis in Myanmar, while in the rest it is on a monthly basis.

Source: Data for Cambodia is from the Cambodian Development Research Institute and the Phnom Penh Post. For Vietnam, the data is available from CEIC. As for Myanmar and Laos PDR, the data is compiled from local newspapers.

Figure 18. USD Index



Note: The USD index is calculated against Cambodia's major trading partners weighted with the share of exports.

Source: CEIC, AMRO staff calculation

22. **Another external risk to growth could stem from the escalation of the U.S. – China trade war, even though its overall impact on Cambodia is mixed.** The escalation of the U.S. – China trade war, if it triggers a weaker growth in these two economies with spillovers on the rest of the world, will dampen Cambodia's growth prospect through exports, investment and tourism. With the increasing presence of Chinese investments and tourists in Cambodia, weaker growth as well as policy changes in China will have a significant impact on investment inflows and tourist arrivals.[12] However, Cambodia may get a positive spillover to the clothing industry through trade diversion and production relocation, leveraging on its still relatively cheap labour and abundant young labour force. AMRO's estimate suggests that the impact of the trade war on Cambodia's overall industrial production is positive in the long run, driven mainly by the garment sector (Figure 19).[13] The services sector, however, appears to be hardest-hit sector, which could be due to an economic slowdown in Cambodia's major

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[11] During the period of 2013 - 2017, garment export growth has steadily and steeply decelerated from 17.8 percent in 2013 to 7.7 percent in 2017.

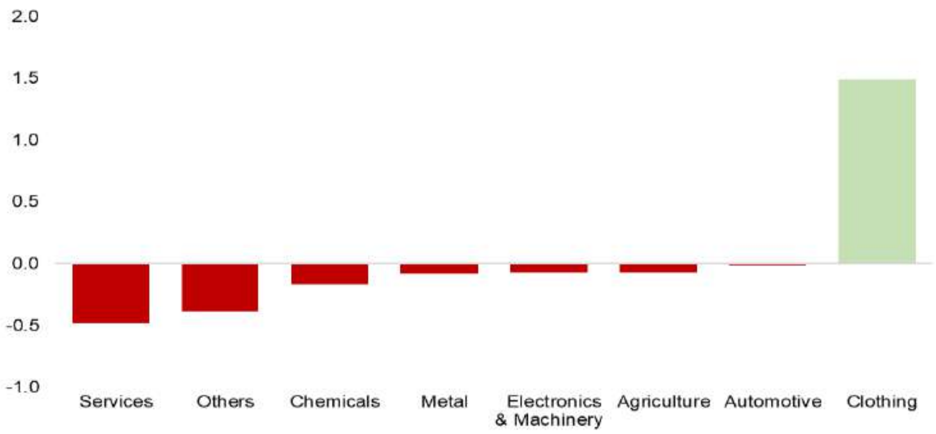
[12] In 2017, Chinese tourists comprised around 22 percent of total tourist arrivals in Cambodia, while FDI inflows to Cambodia from China accounted around 24 percent of total FDI.

[13] Despite a relatively comprehensive framework capturing a global and/or bilateral multi-sector trade linkages through global input-output data base, GTAP has several limitations, and therefore the interpretation should be made with a caution. First and foremost, GTAP is a static model which offers only a snapshot of change from a historical base year to a projected future. It relies on the availability of the input-output data that mostly has some lags. For the case of Cambodia, for example, the latest available data is in 2003 based on Oum Sothea's Input-Output Table, which may fail to capture the recent Cambodia economic structure. However, even though using the 2003 I-O table, the GTAP version 9 uses the 2011 reference database (see https://www.gtap.agecon.purdue.edu/databases/IO/table_display.asp?IO_ID=306). Another major drawback, as in most Computable General Equilibrium Model, is the uncertainty of the parameters. Some parameters are based on a survey of empirical literature, and some are chosen arbitrarily, while the remainder are from the calibration (https://www.researchgate.net/publication/238794649_Computable_General_Equilibrium_Models_A_Literature_Review). However, the exercise in this report is trying to get a sense of which sector will be benefiting from the U.S. – China trade war assuming the structure of the economy remains similar to the base year.

tourist markets, reducing their demand for outbound travelling. The weaker tourism will, in turn, weaken other service sectors such as domestic trade, transportation and communication.

Figure 19. Estimated Impacts of the Trade War on Cambodia's Industrial Production

% Change in Industrial Production (% Point Contribution)



Source: AMRO staff estimates using GTAP Version 9 Database

23. **Risks to financial sector stability emanate from several fronts**. While overall bank loan growth has slowed down to below 20 percent per annum, credit to real estate and construction sectors remains strong, growing 28.8 percent in June 2018. Such a rapid credit growth with increasing credit share[14] could heighten credit risks associated with major correction in the real estate and construction sectors. Another risk to financial stability may come from the rapid expansion of MFIs. While subject to less stringent regulation than commercial banks, MFIs credit expansion has been much faster than commercial banks. A number of large deposit taking MFIs (MDIs) have become larger than some commercial banks, with LTD ratio at more than 200 percent on average. In addition, the recent credit growth slowdown, may create distress in the financial sector. The NPL of the commercial banks has been rising while profitability has been declining in tandem with continued loan growth slowdown.

24. **Pressure on government spending is likely to continue in the medium-term.** The authorities' commitment to address infrastructure gap will push up government expenditure going forward. In addition, spending needs for social welfare will likely increase as well to address poverty and inequality and to improve labor productivity. (see Selected Issue 1) Therefore, although revenue collection is expected to remain strong, pressure on government spending will continue to increase with the increasing needs for development spending, with the public wage bill already taking up a significant share of total expenditure.

[14] The share of credit to the real estate and construction sector has elevated from 14.7 percent in 2015 to 20.5 percent as of June 2018.

25. **Cambodia's agriculture sector is susceptible to extreme weather conditions and commodity price fluctuations.** The agriculture sector remains an important sector in the economy, accounting for about 23 percent of total GDP in 2017 and contributing about 36 percent of total employment. The continued recovery in agriculture in 2016 and 2017 was mainly due to favorable weather conditions and better commodity prices, after the severe drought in 2014 cut agriculture sector growth down to 0.3 percent in 2014 from 1.6 percent in 2013. In 2014, the price of rice fell significantly by 15.3 percent or from USD483 per metric ton to USD410 per metric ton.[15] As a result, the export of rice, one of Cambodia's key export commodities, contracted by 5.3 percent as production dropped.

Table 1. Development of Risks in Cambodia

Risks		Likelihood		Size of Impact in 2018 - 2019
		2018	2019	
Domestic	Rapid rising minimum wages			Medium
	Sharp correction in the real estate market			Low
	Pressures on government spending			Medium
External	Sudden change in the E.U.'s trade policy			High
	Esccalation of the U.S. - China trade war			Medium
	Stronger US dollar due to tighter global financial condition			Medium

Notes:

= Low
= Low to medium
= medium
= High

C. Policy Discussions

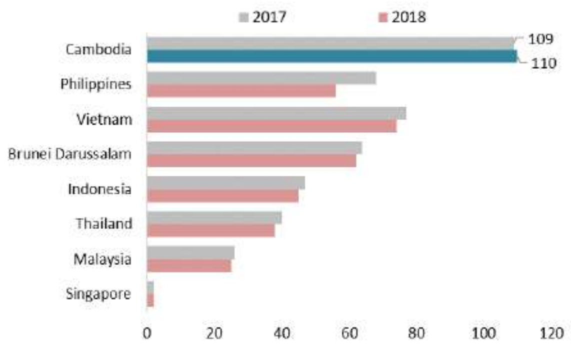
26. **To sustain growth momentum and to enhance resilience in the medium term, it is crucial to maintain external competitiveness while pursuing export diversification.** Cost competitiveness in the garment industry, one of the key growth drivers in Cambodia, has been eroded by rapidly rising minimum wages while other non-labor costs have remained relatively high. The Global Competitiveness Report and the Ease of Doing Business performance[16] have also confirmed Cambodia's worsening competitiveness (Figure 20 and Figure 21). While wage increases should be in line with underlying productivity growth, offsetting past wage hikes requires that Cambodia strengthens its structural policies to improve its competitiveness across other dimensions including trade facilitation, upgrading labor quality, addressing its infrastructure gap, and strengthening governance and regulatory framework. Diversification efforts in terms of export products and markets are also critically important to avoid concentration risks, while trying to move up the value chain in the

[15] In 2017, rice exports contributed the largest share (56 percent) in total agriculture exports, followed by rubber (around 43 percent).

[16] Cambodia's competitiveness ranking (the 2018 Global Competitiveness Report) dropped from 109 in 2017 to 110 in 2018; and Cambodia's position in the ease of doing business rankings, as reported by the World Bank, dropped from 131 in 2017 to 135 in 2018 and slipped further to 138 in the 2019 report.

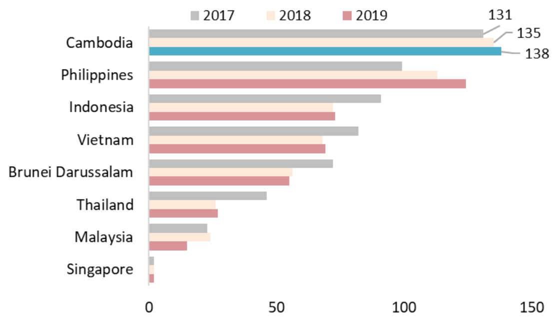
manufacturing sector. The possibility that preferential trade scheme, in particular the E.U.'s EBA, could be removed, should underscore the urgency of such efforts.

Figure 20. Cambodia's Ranking in the Competitiveness



Source: World Economic Forum, the 2018 Global Competitiveness Report

Figure 21. Cambodia's Ranking in the Ease of Doing Business



Source: World Bank, 2018 Ease of Doing Business Report.

27. **Efforts to expand the growth base are critically important to ensure long-term sustainable growth.** Given the relatively narrow growth base, continued efforts to diversify growth drivers are essential, and the tourism-related service sector shows great potential. The tourism industry has been growing rapidly in Cambodia with a sharp increase in tourist arrivals. However, overall tourist spending remains relatively low compared to countries such as Thailand and Vietnam, indicating the potential for the industry to move up market (see Selected Issue 4). Cambodia's less diversified tourism products and less developed supporting infrastructure (both physical and institutional) require appropriate policy for the industry to achieve its full potential.

28. Reprioritizing fiscal resources towards more growth-enhancing spending is essential. Cambodia's infrastructure gap remains large, and public spending on health and education has been relatively low compared to regional peers. If left unaddressed, these shortfalls could become major constraints on Cambodia's growth prospects in the longer-term. In this regard, reprioritizing fiscal expenditure is critical, especially to address the infrastructure gap and to improve human capital, which will facilitate structural reforms to enhance competitiveness and resilience. Strengthening the implementation of the PFM Reform Programs is important to enhance the efficiency and quality of government spending. Current expenditure growth needs to be moderated by keeping the increase in total public wage bill on a sustainable path. Public sector wages should be an integral part of public administration reforms aiming at efficiency and productivity enhancement while at the same time promoting accountability and transparency. In view of the steady decline in concessional loans as Cambodia graduates from the LICs status, maintaining an adequate level of government deposits is crucial in view of spending pressures over the medium-term as well as the need for a buffer in the event of shocks.

Authorities' Views

29. The government of Cambodia has put priority on infrastructure, health and education sectors as reflected in the increase of budget allocation on those sectors in the last five years, aiming to promote the national competitiveness and boost sustainable economic growth. Even though Cambodia's public spending on infrastructure, education and health are still relatively lower than the neighbouring peers, it has been increasing rapidly. For example, current expenditure on education has increased from 1.6 percent of GDP in 2013 to 2.7 percent of GDP in 2017. If capital spending on education is included, total spending on education stands at 3.1 percent of GDP.

30. While the fiscal position is relatively strong, efforts to improve revenue collection should continue in view of the increasing expenditure needs. The RMS 2014-2018, focusing on administrative improvement and enhanced compliance, has successfully boosted revenue collection over the past few years. Efforts to improve revenue collection should continue, including tax administration reforms such as registration and data management systems, and tax policy reforms. Modernizing the administration such as the introduction of internet-based services remains important as it can provide faster and simpler procedures to the tax payers.

Authorities' Views

31. The authorities elaborated that all policy recommendations to sustain revenue collection are now covered in the Revenue Mobilization Strategy 2019 – 2023[17], which aims to modernize tax policy and tax administration to ensure sustain revenue collection and economic growth.

32. Continued vigilance over the financial system through sound prudential policies and enhanced supervision will help maintain financial stability. With monetary policy constrained by the high degree of dollarization, a series of prudential measures has been introduced to enhance risk management in the financial system. The full implementation of new capital requirements for both banks and MFIs, and the continued phase-in of the minimum liquidity coverage ratios have enhanced the soundness of financial institutions and resilience of the financial system. The recent introduction of Prakas[18] on Credit Grading and Impairment Provision will help the assessment and mitigation of credit risks. The adoption of IFRS-9 is a welcome development, while allowing for an extended timeline for implementation so that banks can build up compliance capacity (see Box A). Further efforts to mitigate the risks stemming from the rapid credit growth to real estate and construction sector are recommended including a closer monitoring and supervision of financial linkages of this sector. Supervisory capacity also needs to be strengthened further to cope with the large number of banks and MFIs, as the need for timely assessment and policy calibrations is growing. Given the high

[17] At time when the report was written, the document had not been made available publicly.

[18] Prakas refers to a regulation issued by a Minister, or by the Governor of the National Bank of Cambodia concerning banking or financial issues.

level of dollarization, building sufficient foreign reserves as a buffer against external financial risks and domestic liquidity shocks continues to be critical.

Box A. IFRS 9: The Challenges of New Financial Standards

The implementation of the new accounting standard—International Financial Reporting Standard (IFRS) 9—is one of the key challenges facing the financial system. In July 2014, the International Accounting Standards Board introduced the final IFRS 9 guidance on the expected credit loss model[19] of impairment accounting. The objective of IFRS 9 is to rectify a major perceived weakness in the incurred loss approach[20] that has been criticized and believed to have contributed to the Global Financial Crisis during 2007 and 2008. The International Accounting Standard 39 (IAS 39), the ongoing standard, resulted in “too little, too late”, which means that the model did not require the financial sector to provision at a high enough level for the loan losses observed. Currently, the NBC is encouraging domestic banks to comply with this new standard which will likely implemented fully in the near future.

The two main issues with IAS 39 are loan classification and impairment requirements. Prudential regulations often encompass asset classification systems requiring loans to be classified into buckets. Buckets are usually defined by days past due (DPD)[21] and/or creditworthiness. Table A1 illustrates the new three stages of credit risk converted from the current five stages[22]. Stage 1 (performing) includes financial instruments with no significant increase in credit risk since initial recognition, or financial instruments that have low credit risk at the reporting date. Stage 2 (Under-Performing) includes financial instruments with ‘significant deterioration in credit quality’ since initial recognition, but with no objective evidence of impairment. Stage 3 (Non-performing) comprises financial instruments for which objective evidence indicates impairment at the reporting date. In terms of impairment requirements (Table A2), the IAS 39 recommends the use of *the incurred loss model*[23], which recognizes a credit loss in the profit and loss account. This approach recognizes losses after they have been incurred on a financial asset as a specific percentage of gross loan, leading to provisions deemed too low. In the impairment requirements of IFRS 9, *an expected credit loss model* is introduced in order to make provisions in line with actual expectations of losses rather than incurred losses. The shift to expected losses requires the estimated present value of all expected cash shortfalls over the expected life of the financial asset which means expected loss need to be calculated from the moment a loan is initiated.

Table A1. Loan Classification

	Current	IFRS 9
	Normal	Performing
	Special mention	Under-Performing
NPL	Substandard	Non-performing
NPL	Doubtful	
NPL	Loss	

Source: NCB, IASB

Table A2. Impairment Requirements

Current – Incurred Loss		IFRS 9 – Expected Loss	
Normal	1%	Performing	1-yr EL
Special mention	3%	Under-Performing	Lifetime EL
Substandard	20%	Non-performing	Lifetime EL
Doubtful	50%		
Loss	100%		

Source: NCB, IASB

[19] Expected loss is the sum of the values of all possible losses, each multiplied by the probability of that loss occurring. The Expected Loss of a portfolio is assumed to equal the proportion of obligors that might default within a given time frame, multiplied by the outstanding exposure at default, and once more multiplied by the loss given default rate.

[20] Impairment losses (and resulting write-downs in the reported value of financial assets) can only be recognized when there is an evidence that they exist (have been incurred)

[21] Days Past Due (DPD) refers to loan on which payments are not being made on time and which is number of days behind schedule.

[22] In case of Cambodia, the institution should classify facilities into five categories: Normal (payment on time), Special mention (DPD 30 days), Substandard (DPD 60 days), Doubtful (DPD 90 days), and Loss (DPD 180 days).

[23] Prakas (number B7_017_ 344 Prokor) on Credit Risk Grading and Impairment Provisioning, dated December 1, 2017.

The expected credit loss approach depends heavily on the quality and availability of credit risk data. A lack of historical credit risk data will make the transition to a new accounting standard more challenging. In particular, financial institutions will need to ensure that expected credit loss models make appropriate use of forward-looking information in making loan loss provision, which is closer to the future value (projected of the future loss) concept and more economically relevant. Thus, the full implementation of IFRS9 requires the collection and tracking of information not used in the previous loss model nor existing regulatory capital approach. To be ready, financial institutions must complete a large multi-disciplinary project combining the skills in finance, risk management, and IT.

For many financial institutions, the adoption of expected credit loss accounting will be a momentous accounting change. The expected credit loss impairment model of IFRS 9 has a considerable impact on capital resource planning. The regulation requires financial institutions to recognize the credit loss from a financial asset at the first reporting date immediately after origination, and to create an allowance to cover such future expected loss, which may significantly change the provisions for loss. If there is a shortfall of provisions against the regulatory expected credit loss, financial institutions must deduct this shortfall from their Common Equity Tier 1 (CET1) capital. This would be of serious concern to the senior management of financial institutions, regulators, and investors.

The stepwise recognition of loan losses in Stage 1 and Stage 2 will often lead to an over- or understatement of loan loss allowances. The initial recognition of 12- month expected credit losses in Stage 1 is somewhat arbitrary and lacks conceptual justification. The magnitude of these will depend on how financial institutions apply the IFRS 9 requirements, how soon they incorporate relevant information and update loan loss allowances. This is particularly an issue with regard to financial assets moving from Stage 1 to Stage 2 and the corresponding switch from 12-month expected credit losses to the recognition of lifetime expected credit losses. If financial institutions are not able or willing to identify 'significant increases' in credit risk on a timely basis, the switch from Stage 1 to Stage 2 will result in significant cliff effects, such as abrupt and significant increases in loan loss allowances, creating the same problems as IAS 39.

In order to be compatible with the most imminent changes in the IFRS accounting framework, the prudential rules need to be recalibrated to offset the changes of the new accounting model before IFRS 9 comes into force. Under the current capital regime, CET1 ratios[24] are expected to decrease without a corresponding change in the level of risk, risk appetite, financial institutions' strategy, management or level of losses. The increased cost of capital is expected to impact financial institutions' lending practices, potentially passing to their customer the increased requirements through pricing. Financial institutions can adjust to higher capital requirements either by raising fresh capital or by deleveraging. This adjustment will need to take place against the backdrop of operating conditions that leave the return on equity of many financial institutions below the cost of funding.

33. **The continued build-up of foreign reserves is recommended.** Despite significant improvement in its foreign reserve buffer, Cambodia's economy remains relatively vulnerable to external shocks, with its narrow export base and dependence on external funding for investment. Therefore, it will be prudent for the authorities to continue building up foreign reserves as a buffer against external shocks as well as against domestic liquidity shocks, given the high degree of dollarization of the financial system and the economy.

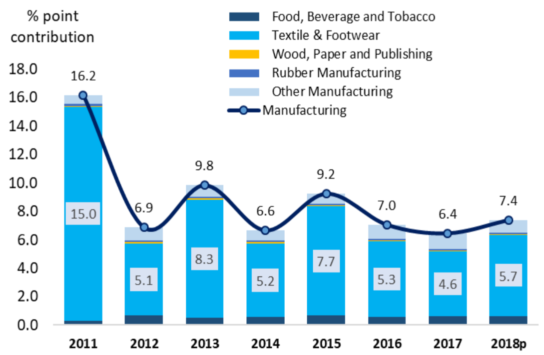
[24] Ratio of core equity capital to risk weighted assets under Basel III

Appendices

Appendix 1. Selected Figures for Major Economic Indicators

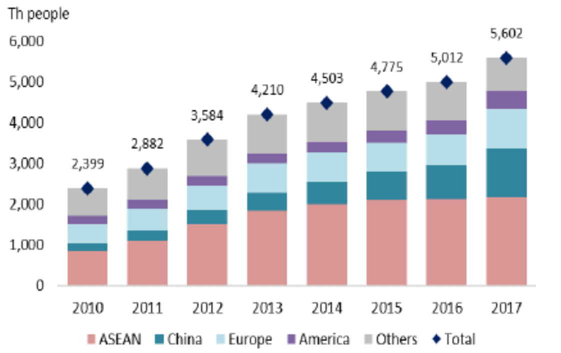
Figure 1.1. Economic Growth and Real Sector

The garment industry, although growing slower than before, is still dominating manufacturing sector growth.



Source: National Authorities, AMRO staff calculation

Tourist arrivals rose significantly in 2017, mainly from China and Europe.

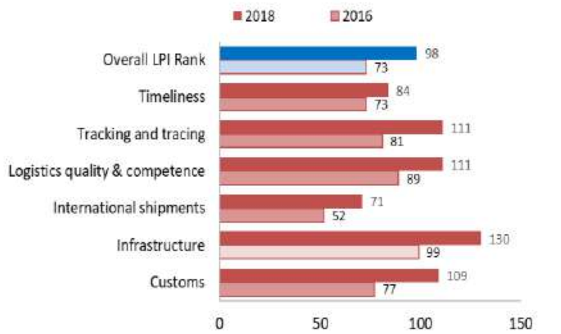


Source: National Authorities, AMRO staff calculation

While the number of construction projects keeps increasing, its value has started to decline

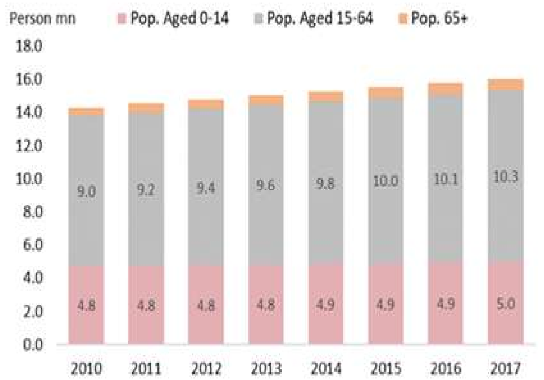
Source: National Authority, AMRO staff calculation

Cambodia's ease of doing business and competitiveness ranking have declined partly due to relatively poor logistic conditions



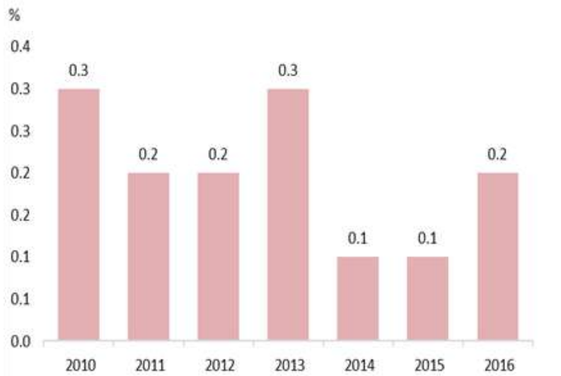
Source: World Bank

Cambodia has a large and growing share of working age population



Source: National Authority, AMRO staff calculation

Despite rising in 2016, unemployment rates has been very low in Cambodia.



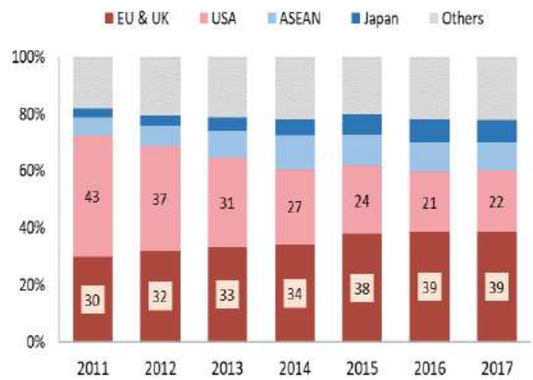
Source: National Authority, AMRO staff calculation

Figure 1.2. External Sector

The rebound of exports in the first nine months of 2018 has been mainly driven by the garment sector

Sources: GD Custom, AMRO staff calculation

E.U. and U.K. and U.S.A. remain key export markets for Cambodia

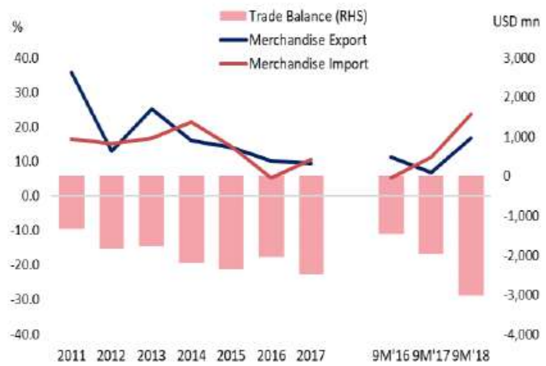


Sources: GD Custom, AMRO staff calculation

Imports surged in the first nine months of 2018, driven mainly by garment-related materials and consumption goods, including vehicle

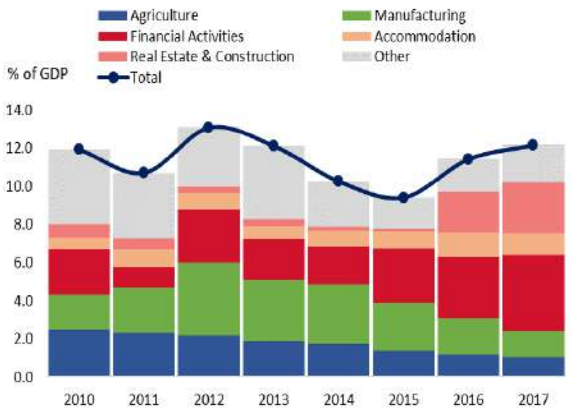
Sources: GD Custom, AMRO staff calculation

The trade deficit increased as import growth outpaced export growth.



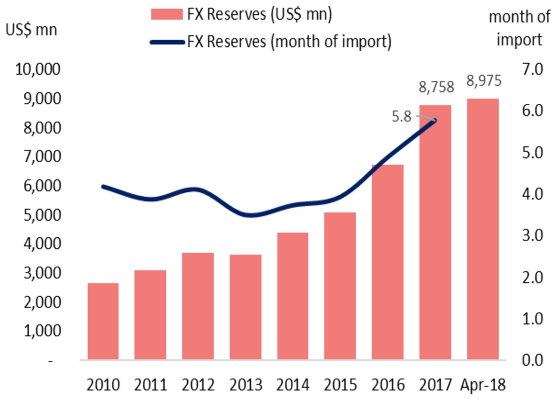
Sources: GD Custom, AMRO staff calculation

FDI inflows remain strong, especially in the financial sector and real estate-related sector.



Sources: NBC, AMRO staff calculation

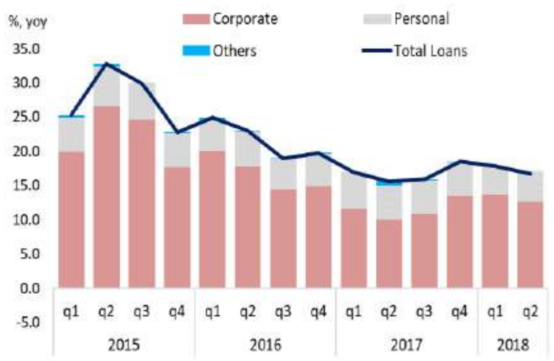
The continued surplus in the overall balance of payments led to accumulation of international reserves.



Sources: NBC, AMRO staff calculation

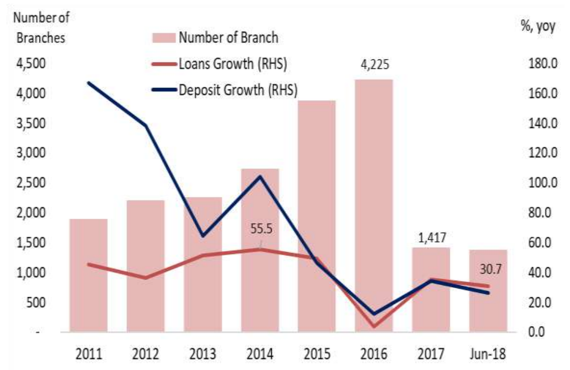
Figure 1.3. Financial Sector

Domestic credit growth from commercial banks to the private sector softened with a slight pickup in Q4 2017, especially credit to the corporate sector.



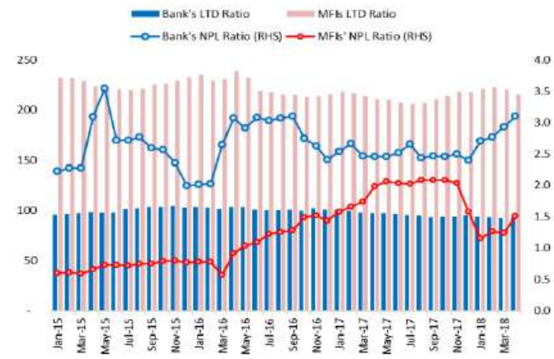
Source: NBC, AMRO staff calculation

Despite slowing down, loan growth in MFIs remained relatively high, at around 30.7 percent in the first half of 2018.



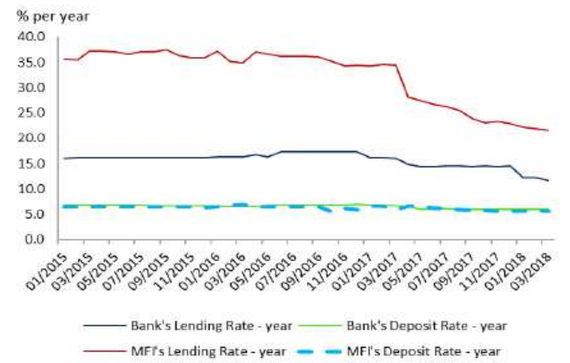
Source: NBC, AMRO staff calculation

Banks' LTD ratio has trended down, deposit growth remained relatively strong while credit growth slowing down.



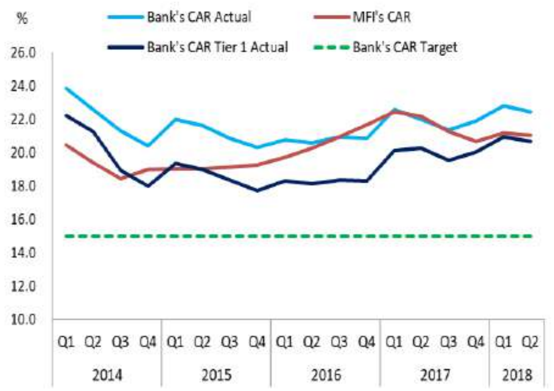
Source: NBC, AMRO staff calculation

MFIs lending rate has continued to decline after the interest rate cap policy, but remains relatively high, above 20 percent per annum



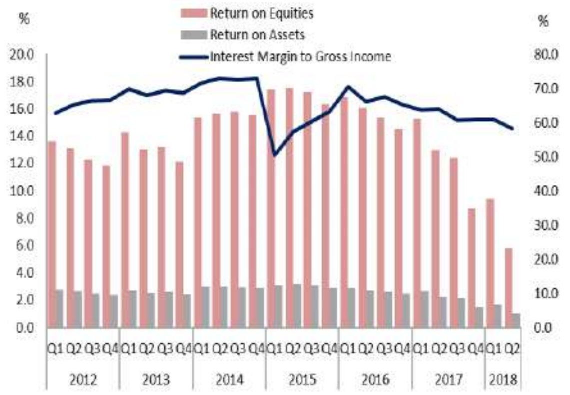
Source: NBC, AMRO staff calculation

The CAR of both the banking sector and MFIs are well above the regulatory target and have been increasing with an increase in minimum capital requirement.



Source: NBC, AMRO staff calculation

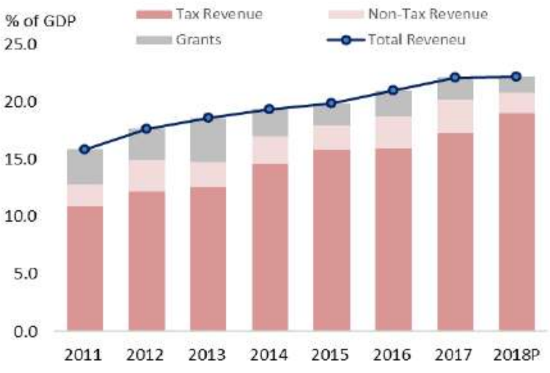
Amid moderating credit growth in tandem with lower interest rate, profitability has declined, as indicated by falling net interest margins, ROE and ROA.



Source: NBC, AMRO staff calculation

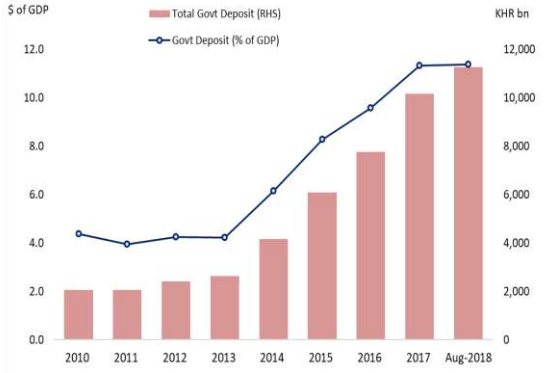
Figure 1.4. Fiscal Sector

The tax to GDP ratio has continued to increase considerably since 2014 with the success of the Revenue Mobilization Strategy 2014-2018



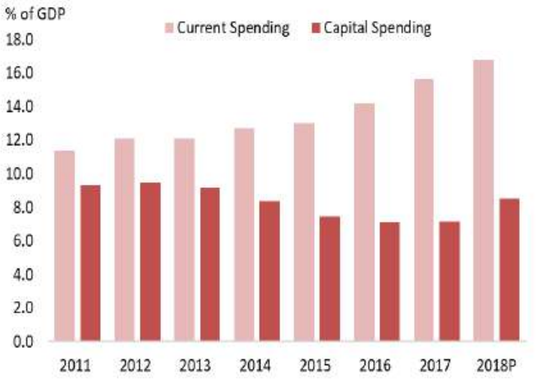
Source: MEF, AMRO staff calculation

Sustained current budget surpluses have allowed the government to build up deposits.



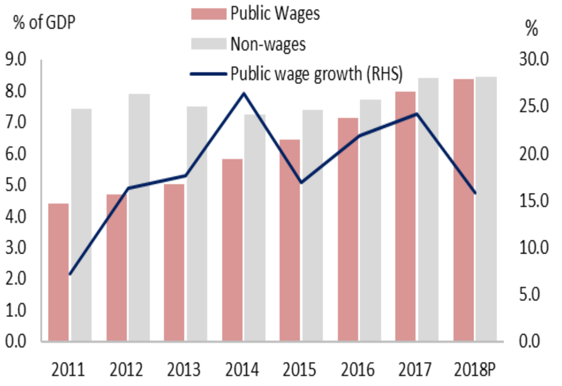
Source: MEF, AMRO staff calculation

After declining over the past few years, capital spending as a share of GDP is expected to pick up in 2018, while current spending continues to increase.



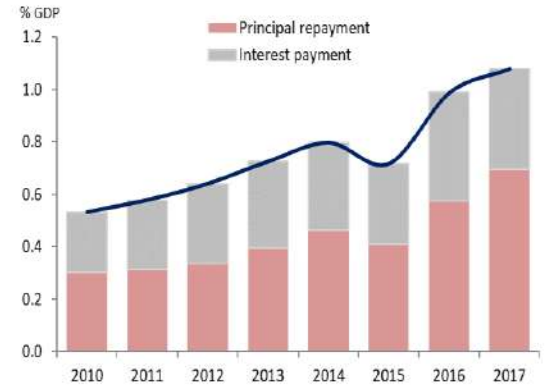
Source: MEF, AMRO staff calculation

The increasing current spending has been driven mainly by strong growth in public sector wages.



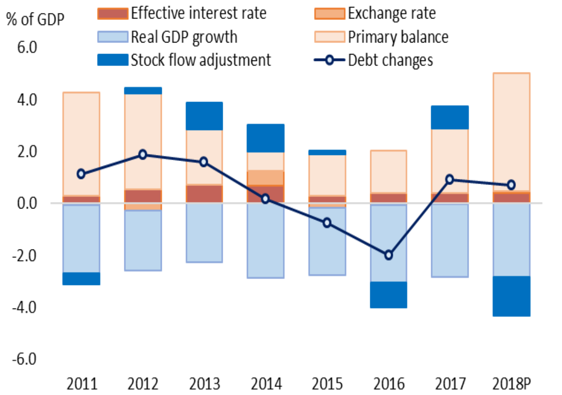
Source: MEF, AMRO staff calculation

Despite increasing lately, interest payment remains low as most of the debt is concessional.



Source: MEF, AMRO staff calculation

The debt to GDP ratio has started to pick up again with the increasing primary balance deficit.



Source: MEF, AMRO staff calculation

Appendix 2 Selected Economic Indicators for Cambodia

	2014	2015	2016	2017	Projection 2018	Projection 2019
National income and prices	(Annual percentage change unless otherwise specified)					
Real GDP	7.1	7.0	7.0	7.0	7.2	7.1
Agriculture	0.3	0.2	1.3	1.7	1.8	1.9
Construction	20.0	19.2	21.8	18.0	17.8	17.2
Garment Manufacturing	6.6	9.8	6.7	5.8	6.4	6.0
Private Consumption	4.5	5.9	6.7	4.6	4.9	5.1
Government Conusmption	2.4	4.4	5.7	6.5	6.8	6.2
Gross Investment	8.8	9.9	10.0	6.0	7.9	8.3
Consumer price inflation (average)	3.9	1.2	3.0	2.9	2.6	2.9
Balance of payments	(In millions of U.S. dollars unless otherwise specified)					
Trade balance	-3,852	-3,949	-3,846	-4,278	-4,935	-5,147
Services, Net	1,727	1,712	1,602	1,878	2,286	2,529
Current account balance	-1,418	-1,573	-1,697	-1,801	-2,191	-2,284
In percent of GDP	-8.5	-8.7	-8.5	-8.1	-9.0	-8.5
Overall balance	754	775	873	1,631	1,570	1,534
Gross international reserves	4,391	5,093	6,731	8,758	10,328	11,862
In months of imports of goods & services	3.7	3.9	4.9	5.8	6.1	6.5
External Debt	7,188	8,694	9,754	11,438	12,679	13,975
In percent of GDP	42.8	48.2	48.7	51.6	51.9	51.9
General government	(In percent of GDP)					
Revenue and grants	19.4	19.9	20.9	22.0	22.0	21.9
of which: tax revenue	14.7	15.8	15.9	17.3	18.2	18.2
Expenditure	21.1	20.4	21.3	22.8	24.3	24.4
Current Expense	12.7	13.0	14.2	15.7	16.3	16.4
Net Acquisition of Non-Financial Assets	8.4	7.4	7.1	7.2	7.9	8.0
Current Net Lending/Borrowing	4.1	4.8	4.3	4.3	4.2	4.2
Net Lending/Borrowing	-4.0	-2.4	-2.7	-2.7	-3.6	-3.7
Government Debt	31.8	31.2	29.2	30.1	31.0	31.5
Monetary sector	(Annual percentage change unless otherwise specified)					
Domestic credit	28.5	24.3	21.9	15.6	17.9	19.0
Private sector	31.3	27.1	22.5	18.5	18.5	18.8
Broad money	29.9	14.7	17.9	23.8	18.8	20.3
Memorandum items:						
Nominal GDP (in billions of riels)	67,740	73,423	81,242	89,754	99,102	109,323
Nominal GDP (in millions USD)	16,778	18,050	20,017	22,158	24,431	26,911
GDP per capita (USD)	1,099	1,163	1,270	1,384	1,485	1,612
Exchange rate (Riels per USD, average)	4,038	4,068	4,059	4,051	4,056	4,062

Note: All figures for 2018 – 2019 are AMRO Staff projections.
Sources: MEF, NBC, NIS, AMRO staff projection.

Appendix 3 Balance of Payments

Items	Unit	2014	2015	2016	2017
Current account	**USD mn**	**-1,418**	**-1,573**	**-1,697**	**-1,801**
Trade balance	USD mn	-3,852	-3,949	-3,846	-4,278
Exports, f.o.b.	USD mn	8,170	9,336	10,273	11,224
Imports, f.o.b.	USD mn	12,022	13,285	14,119	15,502
Services, net	USD mn	1,727	1,712	1,602	1,878
Receipts	USD mn	3,811	3,955	4,033	4,608
Payments	USD mn	2,084	2,242	2,430	2,730
Primary income, net	USD mn	-906	-972	-1,014	-1,103
Receipts	USD mn	332	354	377	442
Payments	USD mn	1,239	1,326	1,391	1,545
Secondary income, net	USD mn	1,613	1,636	1,561	1,702
of which: official tranfer	USD mn	589	526	506	540
Others	USD mn	1,024	1,110	1,056	1,162
Capital and financial account	**USD mn**	**2,282**	**2,378**	**2,455**	**3,274**
Capital account	USD mn	268	265	283	237
Financial account (net)	USD mn	2,014	2,113	2,172	3,037
Direct investment	USD mn	1,677	1,654	2,127	2,477
Other investment	USD mn	359	474	46	566
Errors and omissions	USD mn	-109	-30	115	157
Overall balance	USD mn	754	775	873	1,631
Changes in reserves (-=increase)	USD mn	-754	-775	-873	-1,631
Memorandum items:					
Exports of goods and services	USD mn	11,980	13,291	14,306	15,832
Imports of goods and services	USD mn	14,106	15,528	16,550	18,231
Trade account (% GDP)	% of GDP	-23.0	-21.9	-19.2	-19.3
Current account (% GDP)	% of GDP	-8.5	-8.7	-8.5	-8.1
Capital and financial account (% of GDP)	% of GDP	13.6	13.2	12.3	14.8
Overall Balance (% of GDP)	% of GDP	4.5	4.3	4.4	7.4
International reserves (In millions of USD)	% of GDP	4,391	5,093	6,731	8,758
In months of imports of goods and services	No of months	3.7	3.9	4.9	5.8
GDP (In millions of USD)	USD mn	16,778	18,050	20,017	22,158

Source: NBC, AMRO Staff calculation

Appendix 4 Statement of General Government Operations

In percent of GDP

Items	2014	2015	2016	2017	2018B
Total Revenue & Grants	**19.4**	**19.9**	**20.9**	**22.0**	**20.1**
Total Domestic Revenue	**17.0**	**18.0**	**18.6**	**20.1**	**18.8**
Current Revenue	16.8	17.8	18.5	19.9	18.6
Tax revenue	14.7	15.8	15.9	17.3	16.1
Domestic Taxes	12.1	13.2	13.5	15.1	14.0
Direct Taxes	2.9	3.4	3.6	4.2	3.9
Indirect Taxes	7.9	8.4	8.9	9.7	9.1
Other Dom. Taxes	0.4	0.4	-	-	-
Local Gov't Taxes	0.9	1.0	0.9	1.1	0.9
Trade Taxes	2.6	2.6	2.5	2.2	2.2
Non-tax revenue	2.1	2.0	2.5	2.7	2.4
Capital Revenue	0.3	0.2	0.1	0.2	0.2
Grants	2.3	1.9	2.3	1.9	1.4
Total Expenditure	**21.1**	**20.4**	**21.3**	**22.8**	**24.6**
Current Expenditures	12.7	13.0	14.2	15.7	16.8
Wages and Salaries	5.8	6.4	7.1	8.0	8.4
Non-Wages and Salaries	6.9	6.6	7.0	7.7	8.5
Interest Payment	0.3	0.3	0.4	0.4	0.4
Domestic	- 0.3	0.0	0.0	- 0.0	-
Foreign	0.7	0.3	0.4	0.4	0.4
Capital Expenditures	8.4	7.4	7.1	7.2	7.8
Domestic Financed	2.1	2.4	2.4	2.5	3.2
Foreign Financed	6.3	5.1	4.7	4.7	4.6
Current Net Lending/Borrowing	**4.1**	**4.8**	**4.3**	**4.3**	**1.7**
Primary Net Lending/Borrowing	**-3.7**	**-2.1**	**-2.2**	**-2.3**	**-5.5**
Net Lending/Borrowing (Incl. Grants)	**-1.7**	**-0.5**	**-0.4**	**-0.8**	**n.a**
Net Lending/Borrowing (Excl. Grants)	**-4.0**	**-2.4**	**-2.7**	**-2.7**	**-5.8**

Notes: 2018B refers to Budget Law

Source: GD Budget, MEF and AMRO Staff calculation.

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

Notes:

(i) Data availability refers to whether the official data are available for public access by any means.
(ii) Reporting frequency refers to the periodicity that the available data are published. Timeliness refers to how up-to-date the published data are relative to the publication date.
(iii) Data quality refers to the accuracy and reliability of the available data given that the data methodologies are taken into account.
(iv) Consistency refers to both the internal consistency within the data series itself and its horizontal consistency with other data series of either same or different categories.

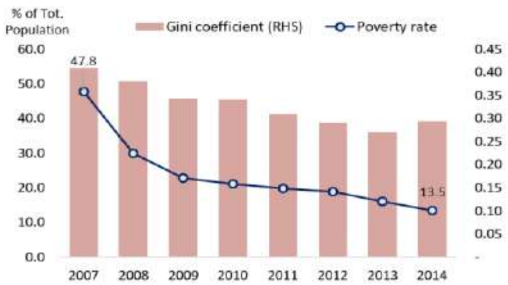
Source: AMRO staff calculations. This preliminary assessment will form the "Supplementary Data Adequacy Assessment" in the EPRD Matrix

Annexes: Selected Issues

Annex 1. Distributional Impact of Fiscal Policy in Cambodia

1. **Cambodia has made substantial progress in poverty reduction over the past decade but less so in addressing inequality.** The poverty rate has declined dramatically from 47.8 percent in 2007 to 13.5 percent in 2018 on the back of strong economic activities. (Figure A1.1) Rapid expansion in the agriculture sector has helped raise rural household income, while those in urban areas have benefitted from the booming garment and construction sectors. Despite the dramatic reduction, however, the poverty rate remains relatively high compared to other ASEAN countries. (Table A1.1) In addition, according to the latest available Gini coefficient[25] data, inequality remains relatively high and has edged up recently. Other human development-related indicators such as school enrolment rate also suggest that Cambodia is still behind its regional peers.

Figure A1.1. Poverty Rate and Gini Coefficient



Source: Ministry of Planning

Table A1.1. Selected Economic and Social Indicators

Indicators	KH	ID	LA	PH	VN
Poverty headcount ratio (% of population)	13.5	10.6	23.4	21.6	9.8
Gini coefficient (World Bank estimate)	29.5	39.5	36.4	40.1	35.3
School enrollment, secondary (% gross)	63.0	86.0	66.5	88.3	92.0
School enrollment, tertiary (% gross)	13.1	27.9	17.2	35.3	28.3
Life expectancy at birth (%)	69.0	69.2	66.7	69.1	76.3
Government spending on education (% of GDP)	1.9	3.3	2.9	3.4	5.7

Note: All figures are based on the latest available data. KH = Cambodia, ID = Indonesia, LA = Lao PDR, TH = Thailand, and VN = Vietnam.
Source: World Development Indicators, retrieved on September 2018

2. **Fiscal policy is the primary instrument to address poverty and inequality.** In addition to a progressive tax system, government expenditures, in particular targeted transfers, can be a key tool in supporting the poor and mitigating income disparity between the rich and the poor. The other budgetary expenditures, such as public education, can also help increase social mobility of the poor by providing them with more opportunities. Fiscal policy, therefore, can play a crucial role in addressing problems of poverty and inequality.

3. **This study aims to examine the distributional impact of some fiscal policy measures in Cambodia.** Using the Commitment to Equity (CEQ) methodology[26], this study analyzes the progressiveness of the tax system and the benefit incidence of some government programs using Cambodia Social Economic Survey (CSES) data. Without appropriate household income information in the dataset, expenditure side information is used to estimate

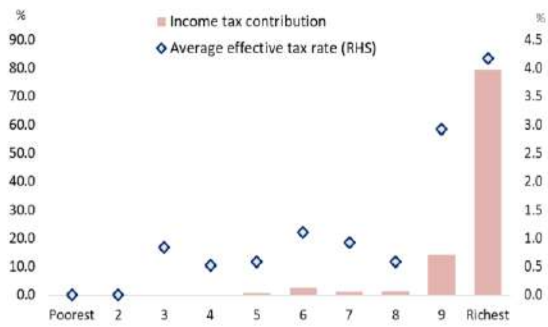
[25] The official Gini coefficient is calculated using the Cambodia Social Economic Survey (CSES) consumption data. The 2015 CSES data captures samples of 3,830 households from all provinces in Cambodia. Income, in this case, is approximated using household expenditures. Total household spending in the CSES data, therefore, is considered as disposable income as it includes all fiscal measures (taxes and transfers). Thus, the Gini coefficient presented in Figure A1.1 is calculated based on disposable income approximated with household expenditures.

[26] The methodology was developed by the CEQ Institute at Tulane University. A detailed discussion on the CEQ methodology is available at http://commitmentoequity.org/publications-ceq-handbook

income levels.[27] Following the CEQ methodology, market income (pre-fiscal income) is derived by working backward from the disposable income (post-fiscal income), taken directly from the CSES by netting out fiscal measures (taxes and transfers).[28]

4. **Tax burden, both individual income tax and property tax, are concentrated in richer households**. Figure A1.2 below shows the distribution of income tax payments across household income groups by decile in 2015.[29] The richest 10 of percent households paid 79.4 percent of total individual income tax collected by the government, while the contribution from the lowest 50 percent was only 1.0 percent. Looking at the effective income tax rate across households, while the magnitude is relatively low, richer households pay a higher proportion of income than poor households, suggesting a progressive individual income tax regime in Cambodia (Figure A1.2). Similarly, Figure A1.3 shows that the top 10 percent households paid 47.0 percent of total property tax collected, while the poorest 10 percent households contributed only 0.7 percent. In terms of the proportion of tax payment to market income, data also confirms that rich households pay a higher proportion of their market income.

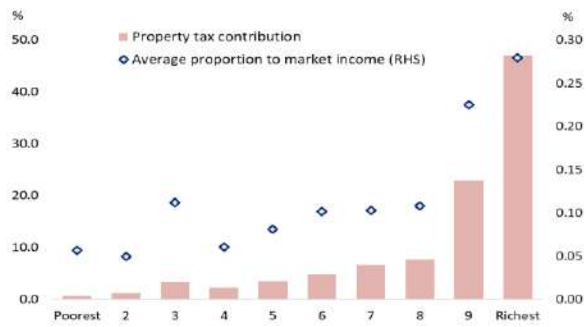
Figure A1.2. . Incidence of Individual Income Tax



Note: Calculated based on household expenditures

Source: NIS, Cambodia Social Economic Survey 2015

Figure A1.3. Incidence of Property Tax



Note: Calculated based on household expenditures

Source: NIS, Cambodia Social Economic Survey 2015

5. **On the spending side, social benefits appear to favor the poor.** Government expenditure on social benefits is designed to be directed more at underprivileged families for a better redistributive effect.[30] Figure A1.4 shows the proportion of the benefits gained, proportion of beneficiaries, and the contribution of social benefits across income groups. While there is no clear pattern in the benefits gained from social benefit across income group, the

[27] Given the high degree of informality in developing countries, it is easier and often more accurate to report expenditures than income. In addition, income may fluctuate much more than it does in advanced countries, and be derived from many sources including irregular transfers and seasonal jobs. Another challenge is a tendency to under-report income.

[28] Market income or pre-fiscal income is defined as income without the government's influence - for example tax and expenditure polices. In the same vein, disposable income or post-fiscal income refers to cash income available after the government has taken away direct taxes (individual income tax) and distributed transfers (social benefits and pensions, which are not separated in the CSES data). Since information on excises and VAT taxes and exemption on goods and services is not available in the CSES data, we were not able to include indirect taxes in the estimation, which means disposable income in this study is conceptually equivalent to consumable income (disposable income minus indirect taxes).

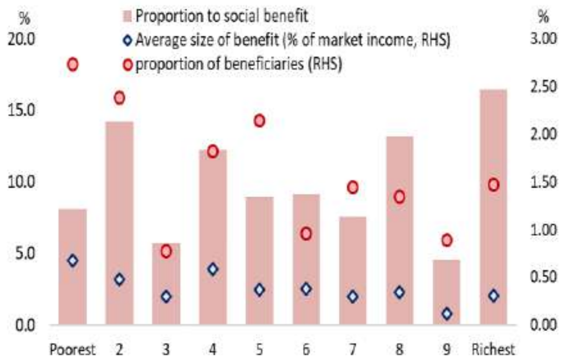
[29] Income groups are classified by the estimated income level from data, rather than some policy based criteria such as income tax brackets. Without microdata on tax collection, this study could not compare the income distribution of the dataset with the real distribution. Although the Gini coefficient calculated from the data is consistent with official estimates, all analyses in this study need to be understood with this constraint.

[30] Social benefits in the CSES comprise of cash transfers and pensions from the government. The cash transfer is mainly in the form of the Maternal and Child Health Program targeting pregnant woman and children under the age of five who are living in poverty. Each eligible woman and child is entitled to receive USD60 to USD90 depending on the fulfillment of the conditions linked to health seeking behavior such us regular check-ups and vaccinations.

proportion of the beneficiaries seems to be higher in the lower income group implying that more poor households are benefitted compared to richer families. In terms of the proportion to market income, social benefits also appears to contribute more to poorer than to richer households, even though the magnitude is relatively small.[31] Of course, this should be interpreted with caution as the social benefits here also includes pension benefits which are not separable in the CSES data.

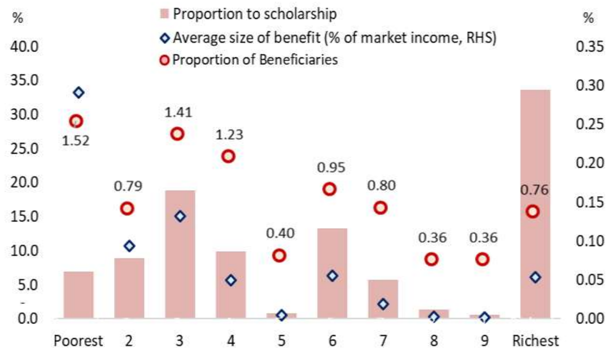
6. **Educational scholarships also seem to be biased towards poor families.** Figure A1.5 shows that the proportion of the benefits gained from scholarships falls more on the higher income group, but in term of the proportion of the beneficiaries, more of the low income families have received scholarships.[32] Its proportion to market income also tends to be higher among the lower income groups, reflecting that scholarships are helping the poorer families more although the magnitude is still relatively small.[33]

Figure A1.4. Incidence of Social Benefits



Note: Calculated based on household expenditures
Source: NIS, Cambodia Social Economic Survey 2015

Figure A1.5. Incidence of Scholarships



Note: Calculated based on household expenditures
Source: NIS, Cambodia Social Economic Survey 2015

7. **As poor households rely more on public health services, they receive more benefits than richer households.** Figure A1.6 illustrates the proportion of beneficiaries of public health spending and out-of-pocket spending across income groups.[34] The proportion of beneficiaries among the bottom 10 percent households was around 21 percent, compared to

[31] One explanation is that this is due to its limited coverage and small amount of transfers with funding depending more on foreign sources, especially World Bank and the United Nations (OECD (2017), the Social Protection Review of Cambodia, *OECD Development Pathways)*. Across the income groups, the coverage ranges from 0.77 percent to 2.73 percent, with overall coverage rate of just 1.5 percent across all households.

[32] The main objective of the scholarship program is to increase grade completion and enrolment rate both at the primary and secondary education levels, especially among those from poor families, as outlined in the Education Strategic Plan 2014-2018. According to the Education, Youth and Sport Performance in the Academic Year 2014-2015 and Goals for the Academic Year 2015-2016 Report (available at https://drive.google.com/file/d/0B1ekqZE5ZIUJVzF4RC1nQ0FXZW8/view), the Scholarship Program for Poor Students covers 68,234 primary school students, 70,494 lower secondary school students and 3,600 upper secondary school students. Each eligible student receives USD40 per year for the primary and the lower level of secondary school, while students in the upper level of secondary school get USD90. Besides the government scholarship, some private institutions also provide scholarships to student, albeit much smaller ones in terms of coverage compared to the ones offered by the government. Scholarships from private institutions are more merit-based.

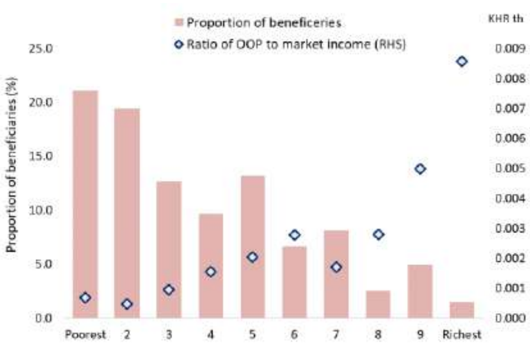
[33] One reason is due to its relatively small coverage and amount of scholarship. Based on 2015 CSES data, the coverage of the scholarship program is only 0.8 percent, measured by the ratio of households that benefitted from scholarships to total households. Meanwhile, the average amount of the scholarships is only around USD5 dollar per month for primary school students and lower secondary school students and USD7.5 per month for upper secondary school students.

[34] The benefit from government spending on health is measured by the number of people across income groups availing of public health services. Since the CSES does not record the number of visits, anyone who has availed of public health services is considered as a beneficiary. The out-of-pocket spending is the amount of money spent by each of income group from their own pocket in seeking health services.

1.5 percent among the top 10 percent of households by income. Meanwhile, the average out of pocket spending on health services of the bottom 10 percent households is a lot lower compared to the top 10 percent of households. Data shows that poor households seem to rely more on public health services, which could be due to the richer households' preference for private hospitals that offer higher quality of services.

8. **The benefit of education seems to be distributed more evenly across income groups**. Figure A1.7 depicts the proportion of beneficiaries of government spending on education and the out-of-pocket spending across income groups.[35] The proportion of beneficiaries of government spending on education is distributed relatively evenly as compared to other forms of social spending. The proportion of beneficiaries in the bottom 10 percent of households is about 10.8 percent of total beneficiaries, slightly higher than the 8.1 percent of the richest 10 percent of households that have benefited. In terms of out-of-pocket spending, however, the richest 10 percent households spent almost five times more than the poorest 10 percent on education, which could be due to extra-curricular activities at school such as tutorials, foreign language courses and so forth.

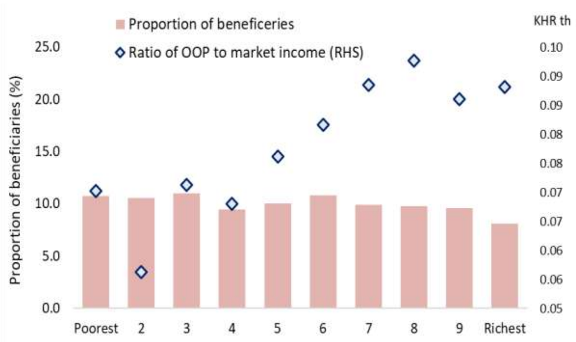
Figure A1.6. . Incidence of Government Spending on Health



Note: The proportion of beneficiaries equals the ratio of the number of people availing of public health services in each income group to the total population in the corresponding income group. OOP stands for out of pocket spending.

Source: NIS, Cambodia Social Economic Survey 2015

Figure A1.7. Incidence of Government Spending on Education



Note: The proportion of beneficiaries equals the ratio of the number of students atending public schools in each income group to the total population. OOP stands for out of pocket spending.

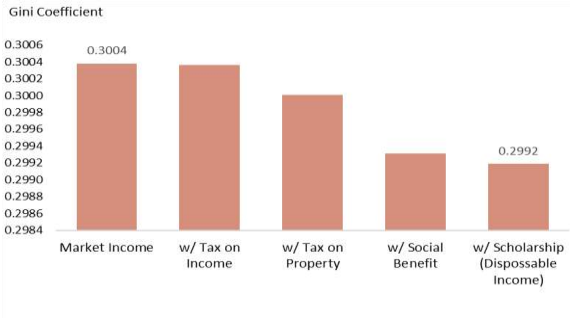
Source: NIS, Cambodia Social Economic Survey 2015

9. **The overall impact of several fiscal instruments examined in this study is broadly reducing income inequality**. Figure A1.8 presents the change of Gini coefficient by each fiscal policy measure, starting from the market income (no fiscal policy measures), adding sequentially each individual policy measure, and ending with all measures being included (disposable income). Even though individual income tax is concentrated largely on richer households, it seems that the distributional effect is relatively small as reflected by a small decline of Gini coefficient from its initial level under market income. The relatively small average effective income tax rate, in particular in the top 30 percent households, may explain why the impact of the individual income tax on Gini coefficient is relatively small. Property tax is observed to have a relatively bigger distributional impact compared to the one under

[35] Similar to spending on health, the benefit of the public education is measured by the number of students attending public school. The out-of-pocket spending pertains to all expenses related to education costs paid without government assistance.

individual income tax as shown in a larger drop in Gini coefficient. On the expenditure side, social benefit seems to have the biggest distributional effect while scholarship makes a smaller contribution. Overall, fiscal policy measures examined in this study have inequality reducing effect but the size of overall impact is found to be relatively small compared with some other developing countries (Figure A1.9).[36]

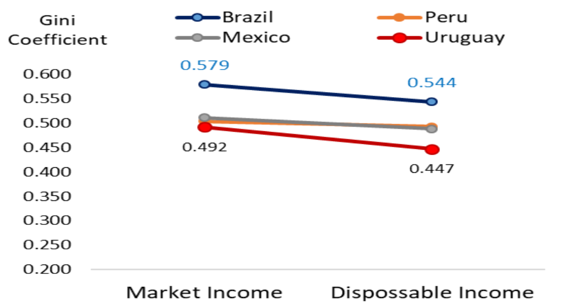
Figure A1.8. Gini Coefficient: From Market Income to Disposable Income



Note: Calculated based on household expenditures in sequential steps starting from market income (no policy measures) and ending with disposable income (include all policy measures).

Source: AMRO staff calculation

Figure A1.9. Fiscal Policy Impact on Inequality in Latin America



Source: Lustig, N. et al (2013) available at http://www.commitmentoequity.org/publications_files/Latin%20America/

10. **Fiscal Policy can play a bigger role in addressing income inequality.** The analysis shows that fiscal policy measures are designed properly enough to be redistributive, but their impact is relatively small. In order to enhance the effectiveness if redistributive fiscal policy, there needs to greater progressivity through better targeting, in tandem with increasing the amount of benefits and their coverage. Nevertheless, Cambodia's Gini coefficient is relatively low compared to other developing and emerging countries. The challenges is how to prevent it from becoming worse.[37]

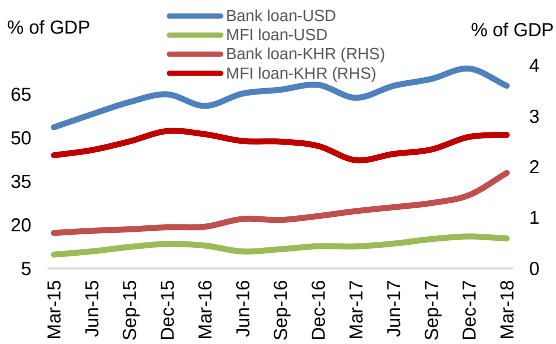
[36] The magnitude of the impact is likely higher if we include spending on health and education. They are not included in the calculation as estimating the in-kind benefits of these two require more detailed data on total government spending on education for each school level and the number of outpatient visits and the cost of provision for each visit. The same kind of detailed data is also needed for inpatient care.

[37] On his article in KfW Development Research (available at: https://www.kfw-entwicklungsbank.de/PDF/Download-Center/PDF-Dokumente-Development-Research/2016-08-04_MF-Klassen-Ungleicheit_EN.pdf), Klasen reported that income inequality has been increasing in many developing countries, notably in China and India.

Annex 2. Impacts of the Interest Rate Cap on Cambodia's MFIs

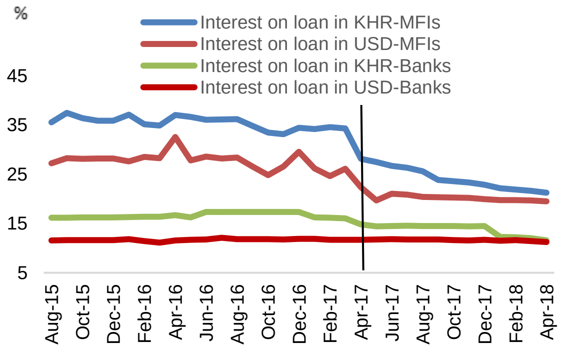
1. **The interest rate cap policy on MFIs was intended to reduce borrowing costs.** The number of MFIs has been growing fast in Cambodia over the past decade – from 17 in 2007 to 76 in 2017. As suggested by the Microfinance Index of Market Outreach and Saturation (MIMOSA) and estimates in the AMRO Country Report 2017, Cambodia's MFI sector has become increasingly crowded. On the other hand, despite potential market saturation and intense competition, the overall lending rate in the MFI sector was high at around 35 percent before the implementation of the interest rate cap, experiencing only a very gradual downward adjustment. For instance, the KHR lending rate, the Cambodian national currency and the major MFIs' main lending currency, was relatively stable at 35.90 percent at the end of 2015 and it moved to 34.36 percent in March 2017, a month before the cap was put in place. Similarly, the USD lending rate decreased from 28.24 percent to 26.16 percent in the same period. To promote affordable loan practices and protect borrowers from high interest-payment burdens, the authorities capped the lending rate of MFIs at 18 percent, effective from April 2017.

Figure A2. 1. Loans as of GDP



Source: NBC

Figure A.2. 2. Lending Rate Movement (Average)



Source: NBC

2. **Although imposed only on MFI loans, the commercial banks' KHR lending has also come under pressure.** A sharp decline in the lending rate in the MFI sector – including for both large deposit-taking MFIs (MDIs) and smaller non-deposit-taking MFIs (NMDIs) – was observed after the introduction of the interest rate cap on 1 April 2017. The weighted average rate for outstanding KHR loans fell from 34.4 percent in March 2017 to 28.1 percent by end-April 2017, and further down to 21.3 percent by end-May 2018. In tandem, the USD lending rate decreased from 26.2 percent to 22.3 and later to 19.5 percent respectively in the periods above. A lower MFI interest rate has also affected the KHR lending margin of commercial banks, although accounting for a relatively small portion of bank loans. Stable at around 16 percent before the cap, bank KHR loan rates fell to 11.7 percent by end-April 2017 and 11.2 percent in April 2018. In comparison, commercial banks' USD lending rate has remained stable even after the implementation of the cap, at around 11 to 12 percent. As a result, the interest rate cap has lowered the KHR lending rate in the MFI and banking sectors while effectively reducing the rate gap between USD and KHR loans.

3. **As interest income has been declining, MFIs have adjusted their pricing strategies to offset the thinner margins, partly by charging more non-interest fees.** All MFIs, previously lending at an above-18 percent annualized rate, have increased non-interest fees in response to the ceiling on the lending rate. Therefore, non-interest income has increased substantially after the cap, helping offset the foregone interest- income. In particular, the smaller non-deposit-taking MFIs, which have higher fixed costs, require a bigger increase in non-interest fees to compensate for lower margins in interest rates. The rising non-interest income accounted for 13.6 percent of small NMDIs' operating incomes, compared to an average of about 3.5 percent for five years before the interest rate cap.

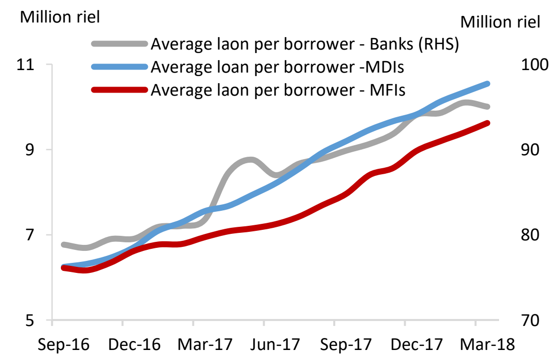
Table A2. 1. More Help for Financial Institutions (Non-Interest Income)

Average fee (KHR thousand)	Types	2016	2017
Per borrower	MDIs	28	71
	NMDIs	55	222
	Banks	1,150	1,390
Per KHR 1 million loan	MDIs	4.2	7.2
	NMDIs	8.6	25.8
	Banks	14.4	14.7

Note: MDIs refers to deposit taking MFIs and NMDIs refers to no-deposit taking MFIs.
Source: NBC

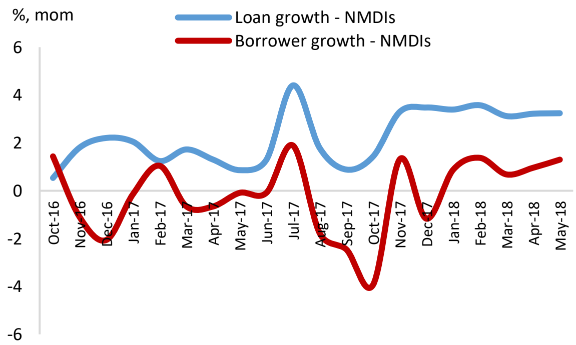
4. **MFIs have also increased the size and the maturity of new loans to reduce operational costs, with the associated risks offset by a greater share of group loans.** Average maturity in MFIs has generally been increasing after the imposition of the cap, and the associated risks with larger loan and longer maturity have partly been offset by more group loans with lower risks than individual loans.

Figure A2. 3. Average Loan Size



Source: NBC

Figure A.2. 4. Loan Growth Rates

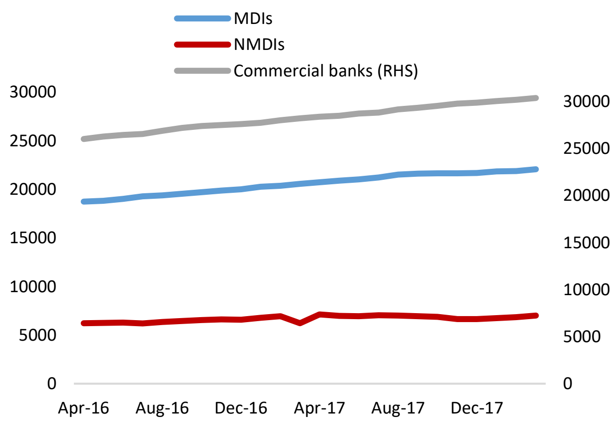


Source: NBC

5. **Meanwhile, rather than consolidating operations by laying off staff, some MFIs have placed more emphasis on reducing other operational costs.** The total number of staff in both MFIs and banks has continued increasing gradually even after the cap. MFIs tend to assign more responsibilities to credit officers by increasing their loan targets. The average loan size per staff in MDIs increased by about 26 percent to KHR727 million per staff in April

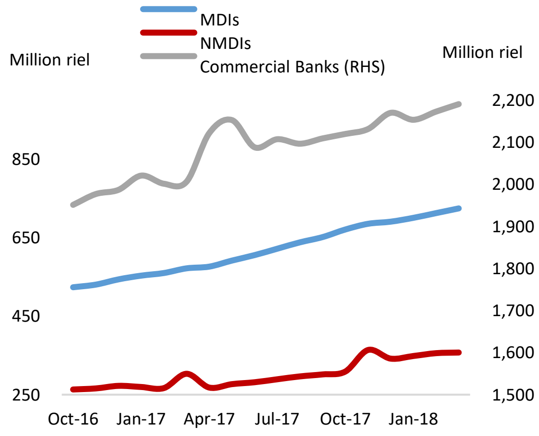
2017, from KHR576 million one year ago. Meanwhile, that of NMDIs rose around 38 percent to KHR 370 million from KHR 269 million in the same period, compared to an increase of only about 9 percent for commercial banks.

Figure A2. 5. Number of Staff



Source: NBC

Figure A2. 6. Average Loan Size per Staff



Source: NBC

6. **Although partly offset by increasing non-interest fees and lowering marketing costs, the profit margins of MFIs have declined after the imposition of the interest rate cap.** The overall profitability of both large and smaller MFIs, measured by ROA and ROE, has declined after the imposition of the cap. In the same period, funding costs such as deposit have edged up slightly, with the KHR deposit rate at 6.8 percent in March 2016 compared to 5.8 percent in March 2017 before the cap.

Table A2.2. Financial Institutions' Profitability Indicators

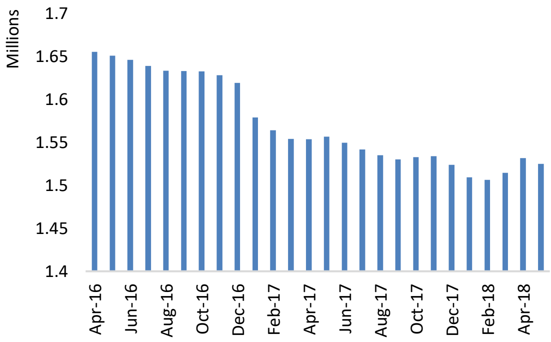
	Institutions	2015	2016	2017
Net Interest Margin (%)	MDIs	11.4	10.9	8.9
	NMDIs	12.1	15.0	12.9
	Banks	4.0	3.8	3.6
Return on Assets (%)	MDIs	4.0	3.6	2.9
	NMDIs	1.8	3.6	2.4
	Banks	2.0	1.8	1.6
Return on Equity (%)	MDIs	23.3	20.6	16.9
	NMDIs	4.8	8.8	5.2
	Banks	11.40	10.38	8.8

Note: Figures are at year end
Source NBC

7. **Further, the pricing adjustment of the MFI sector could have a negative impact on the number of borrowers in the second half of 2017, especially in the case of NMDIs.** With the implementation of the interest cap, most MFIs have tried to target customers with bigger-size loans to reduce operational costs. The average loan size per borrower in MDIs increased to KHR10.5 million in March 2018 from KHR7.5 million in March 2017, while NMDIs' average loan per borrower increased to KHR9.5 million from KHR7.4 million. In tandem, the number of borrowers, from both MDIs and NMDIs, dropped in the latter part of 2017. Besides

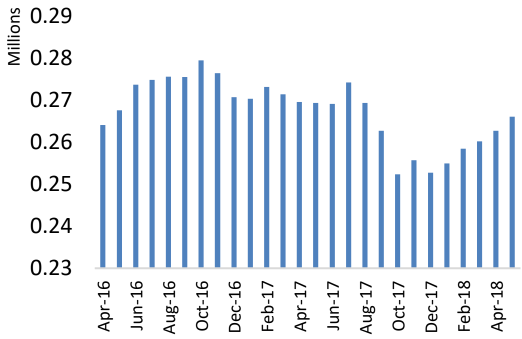
dropping small borrowers given the high cost of operations, MFIs have also tended to drop less creditworthy borrowers or to provide credit to them with higher fees.

Figure A2.7. Number of MDIs' Borrowers



Source: NBC

Figure A2.8. Number of NMDIs' Borrowers



Source: NBC

8. **At the beginning of 2018, there has been a stronger credit growth driven by an increase in KHR loan size, and a rebound in borrowers of MFIs.** MDI loans grew by 35 percent yoy in March 2018, compared to less than 1 percent growth in the previous one-year period. On the other hand, in the same period, NMDI loans, grew at 31 percent in March 2018, up from 27 percent in the previous year. As a benchmark, bank loans grew by 19 percent in this period compared to 16 percent one year ago. The fast credit growth was supported mainly by the growth in KHR loans. Although credit growth temporarily slowed down after the imposition of the cap, MFIs' KHR loans rebounded and grew at 31 percent in the first half of 2018. From a funding perspective, a more active interbank market and NBC KHR liquidity support have also contributed to the faster KHR loan growth.[38]

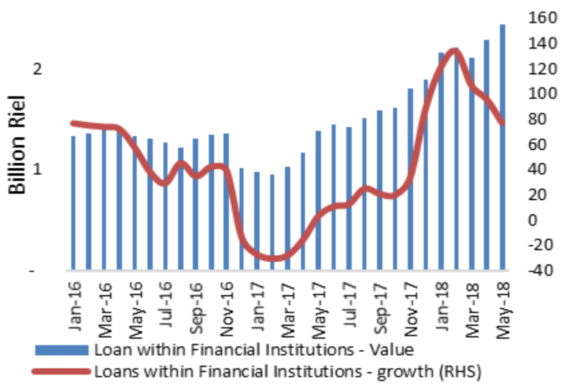
9. **The interest rate cap policy has lowered overall lending costs in Cambodia, benefiting both households and corporates.** There are competing views on the effectiveness of administrative measures such as interest rate caps in lowering the cost of credit, and our investigation also shows mixed results. First, the effective lending rate across financial institutions has been lowered after the interest rate cap, although the drop has been smaller in nominal lending rates, due to higher non-interest fees. Second, MFIs' adjustment in their pricing strategies led to some negative impacts on smaller borrowers. However, increased group loans indicate that some of the smaller borrowers may have come back by pooling together after the initial drop. That said, some smaller borrowers who had access to MFI credit before the cap but now find the borrowing rates too expensive, could end up outside of MFIs' reach and could turn to other unregulated or less-regulated lenders. Third, to maintain business profitability, some MFIs that have access to domestic interbank funding, have also tried to expand their balance sheets amidst potentially stronger credit demand induced by

[38] Liquidity Providing Collateralized Operations (LPCOs) allow financial institutions access to KHR liquidity at a much cheaper rate than the deposit rates they offer. The bidding amount in LPCO tripled to KHR458 billion in the first half of 2018, from just KHR134 billion in the whole of 2017.

lower borrowing costs. Such supply and demand factors contributed to strong credit growth in 2018.

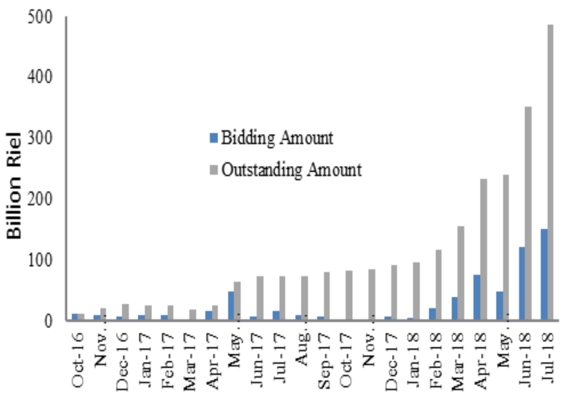
10. **A more competitive environment—induced by the interest rate cap policy—can also help accelerate consolidation in this sector and deepen the domestic financial market**. MFIs have traditionally collected payments by visiting borrowers, but have now changed their practice by encouraging clients to visit regional branches and using third-party transfer networks. While obtaining external funding has become more stringent amidst falling profitability, MFIs have started to tap on domestic bank borrowings which have become more attractive in terms of both cost and maturity. On the other hand, banks are also incentivized to lend to MFIs as they need to increase local currency loans to fulfill the minimum share of loans in local currency.[39] As a result, capital has been better utilized in the domestic market which partly contributes to a lower interest-rate environment.

Figure A2.9. Interbank Financing



Source: NBC

Figure A2.10. Liquidity Providing Collateralized Operations



Source: NBC

11. **While the interest rate cap has decreased lending costs, strong credit expansion and interlinkages between MFIs and banks have increased concern about financial soundness, which implies the need for continuous upgrading of the regulatory framework.** The phase-in of higher liquidity coverage ratios[40], regulations related to credit grading, and impairment provisions will help safeguard the financial system that is becoming increasingly sophisticated. On the other hand, self-regulated mechanisms led by the microfinance association itself could also help mitigate risks from multi-institution lending and refinancing.

[39] The NBC requires all FIs under its authority to have at least 10 percent of loans in national currency and this will be fully implemented by the end of 2019.

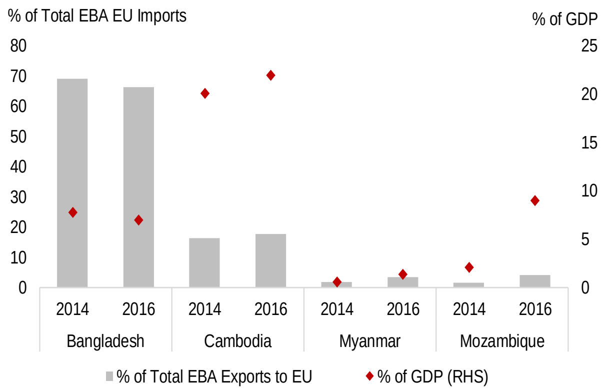
[40] The LCR of banks and MDIs is set to increase gradually to 100 percent by 2020, from 60 percent in 2016 when it was first implemented.

Annex 3. Cambodia's Preferential Trade Schemes: Recent Developments and Risks

1. **Cambodia, as one of the Least Developed Countries (LDCs)[41], is entitled to many preferential trade schemes, allowing the country to export with zero tariff to many advanced economies.** This box gives an overview on Cambodia's Generalized Schemes of Preferences (GSP) with the EU and the U.S., and analyses GSP impacts on the economy, including potential downside risks to the country's preferential trade schemes.

2. **Cambodia has been a beneficiary of EU's Everything But Arms (EBA) since 2001[42].** Of the 49 beneficiaries, Cambodia has so far been the second largest EBA exporter, after Bangladesh (Figure A3.1). Box A3 provides detailed information on what the EBA is and the criteria to get and maintain EBA status. It should be noted that Cambodia's exports to the EU remain largely dominated by garment products[43] although some diversification has been observed as reflected in the rising share of other products, especially bicycles, and electronic and vehicle parts (Figure A3.2).

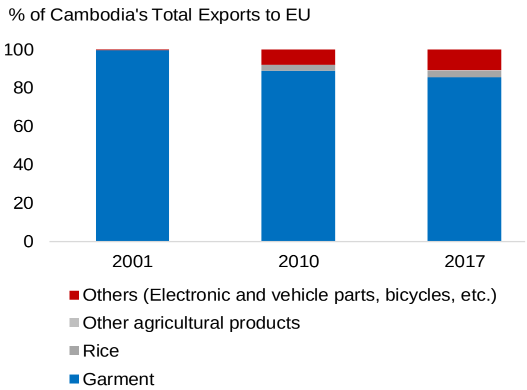
Figure A3. 1: EBA Preferential EU Imports, Top Countries



Note: The latest data is up to 2016

Source: European Commission, IMF, National Authority, AMRO Staff Calculation

Figure A3. 2: Cambodia's Exports to EU by Product



Source: National Authority, AMRO Staff Calculation

Box B: What is Everything But Arms?

Everything But Arms (EBA) is one of the three GSP programs provided by the E.U. to the LDCs with full duty free and quota free access to the EU market for all products, except arms and ammunitions[44]. Founded in 2001, the EBA has been extended to 49 beneficiaries from Africa, Asia, Australia & Pacific, and the Caribbean (Figure B1). In 2016, the E.U.'s total EBA imports amounted to EUR23.5 billion or 38 percent of its total preferential imports, with Bangladesh as the largest EBA exporter, followed by Cambodia (Figure B2 and B3).

Notwithstanding automatic entry into the EBA[45], countries need to fulfil stipulated criteria to maintain the EBA status. To be granted the EBA status, a country has to be on the UN Committee for Development Policy's list of LDCs. Even though the EBA does not have an expiration date, it is required that each country's EBA status be reviewed every three years, paving the way for the E.U.

[41] Status as defined by the United Nations

[42] Source: European Commission's trade document titled "Everything But Arms (EBA) – Who benefits?"

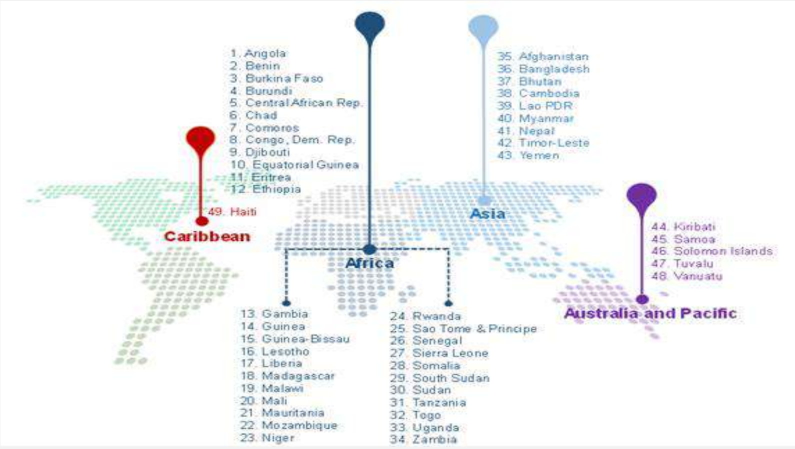
[43] Garment products include clothing, footwear and other related products, such as travel goods and other textile products.

[44] Source: European Commission.

[45] According to the European Commission, "… unlike under the Standard GSP, countries do not lose EBA status by entering into a Free Trade Agreement with the EU. A 'graduation mechanism' for products also does not apply".

Commission to decide whether to renew or suspend the EBA preferences. Temporary withdrawal of the EBA status is expected if the country cannot fulfil criteria as set in the regulation. Listed in Article 19 of the aforementioned regulation are five conditions leading to the temporary withdrawal of status, such as 1) serious and systematic violation of principles as specified in human and labor rights conventions[46], 2) exports of goods produced by prison labor, 3) failure to conduct customs controls in respect of drug exports or transits or to comply with international conventions on anti-terrorism and money laundering, 4) serious and systematic unfair trading practices, and 5) serious and systematic violation of objectives adopted by any international arrangements.

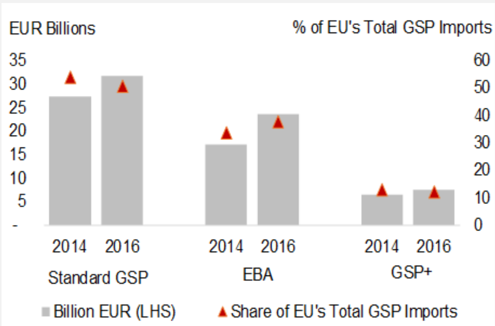
Figure B1. 49 EBA Beneficiary Countries



Note: Samoa will be removed from the list of EBA beneficiary countries from 1 January 2019, according to Commission Delegated Regulation (EU) 2017/217 of 5 December 2016.

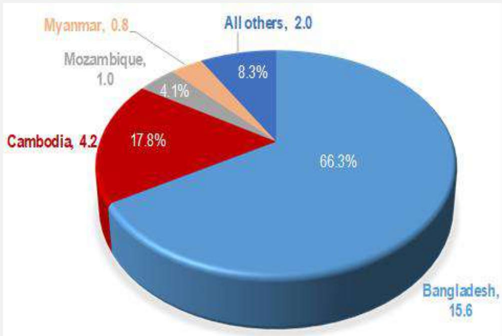
Source: European Union

Figure B2: EU's GSP Imports by Types



Source: European Commission

Figure B3: EBA Imports by Beneficiaries (EUR billions)



Note: Number in % is share of EU's EBA imports

Source: European Commission

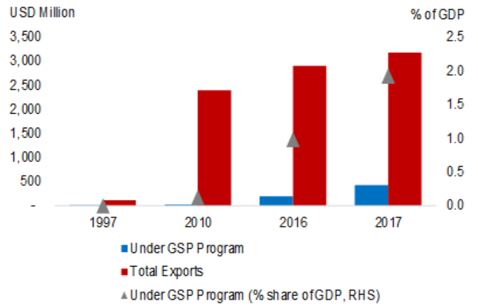
Once the economic status is upgraded to higher level or the country is no longer considered an LDC by the UN, its EBA status will be withdrawn with a generous transition period. To avoid potential trade flow shocks as well as to ensure smooth progression into a new economic status, a three-year transition period will be provided to the countries from whom EBA status is withdrawn, during which they can continue enjoying the EBA preferences. Besides, there are also two other GSP programs, which they can take into consideration moving forward, including Standard GSP (for low and lower-middle income countries), and GSP+ (for vulnerable low and lower-middle income countries).

[46] Some of the core UN/ILO convention for human and labor rights include International Covenant on Civil and Political Rights (1966); Convention concerning Forced or Compulsory Labour, No 29 (1930); Convention concerning Freedom of Association and Protection of the Right to Organise, No 87 (1948); Convention concerning the Application of the Principles of the Right to Organise and to Bargain Collectively, No 98 (1949); and Convention concerning the Abolition of Forced Labour, No 105 (1957).

3. **Cambodia's exports to the U.S. under the GSP program remain relatively small, and are mainly concentrated in travel goods, builders' ware of plastics, plywood and bicycles.** Cambodia is a beneficiary of the program since 1997. In 2017, it exported USD423 million - or 13.3 percent of its total exports to the U.S. - duty free (Figure A3.3a), making it one of the top 10 GSP beneficiary developing countries exporting to the U.S. (Figure A3.3b). Unlike exports to the E.U., Cambodia's GSP export products to the U.S. are more diversified, with travel goods, builders' ware of plastics, plywood and bicycles comprising the largest share (Figure A3.4). The big jump in travel goods exports has been witnessed after the Office of the U.S. Trade Representative announced an expansion of GSP[47], allowing Cambodia to export travel goods[48] to the U.S. duty free, starting from June 2016. This GSP expansion is expected to help promote the development of Cambodia's garment industry into new and higher value-added areas of production. Cambodia's official data showed a significant increase in the export of travel goods from Cambodia to the U.S., amounting to USD229 million for the first six months of 2018, or roughly 89 percent of travel good exports seen in the whole of 2017[49].

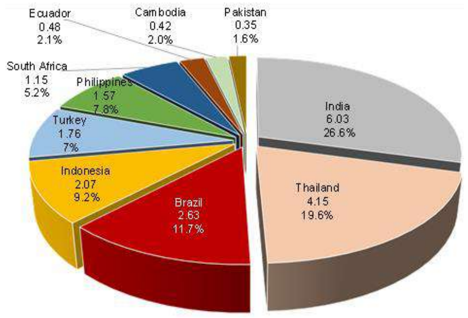
Figure A3.3: U.S. Imports under GSP Program

a. Cambodia's Exports to the U.S.



Source: U.S. International Trade Commission, AMRO Staff Calculation

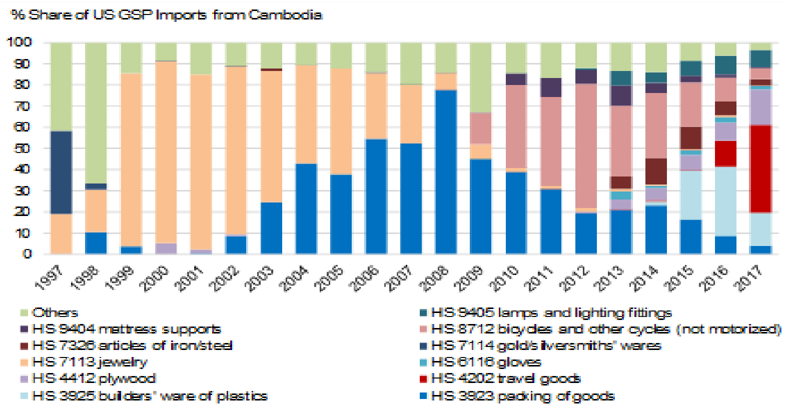
b. Top GSP Beneficiary Developing Countries, USD Billion, 2017



Note: Number in % is the share of U.S. total imports under GSP program. Value refers to CIF import value.

Source: U.S. International Trade Commission, AMRO Staff Calculations

Figure A3. 4: U.S. Imports under GSP from Cambodia by Products

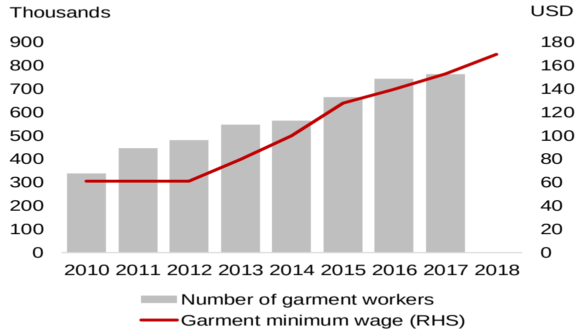


Source: U.S. International Trade Commission, AMRO Staff Calculation

[47] Source: "Duty Free Access for Travel Goods Made in Cambodia", 6 July, 2016, U.S. Embassy in Cambodia
[48] Travel goods include luggage, backpacks, handbags and wallets
[49] Source: Cambodia's Ministry of Economy and Finance

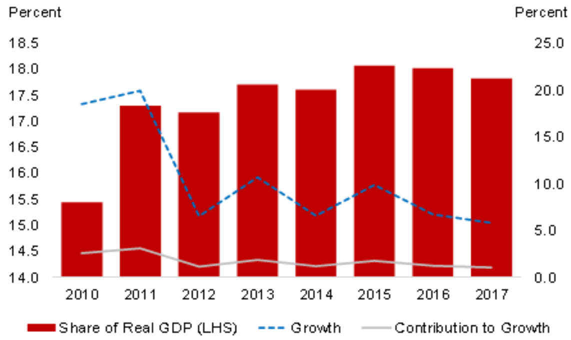
4. **Exports under GSP command a sizable share of GDP and contribute significantly to job creation in Cambodia, especially in the garment sector.** The combined exports under GSP to the EU and the U.S. reached around 23 percent of GDP in 2016 (Figure A3.1 and Figure A3.3a). Thanks to the continued strong growth in garment sector, 763,820 jobs were created in 2017, an increase by 2.7 percent from 2016, while the minimum wage keeps increasing over time (Figure A3.5). The garment industry, as such, has helped improve the livelihoods of Cambodians and, at the same time, spurred economic growth. Garment sector was the second biggest growth driver in 2017, growing at 5.8 percent and accounting for 17.8 percent of real GDP (Figure A3.6).

Figure A3.5. Number of Garment Workers and Minimum Wage



Source: National Authorities

Figure A3. 6. Garment Sector Value Add to GDP



Source: National Authorities

5. **Preferential trade schemes make Cambodia a conducive market to foreign investments; nevertheless, overreliance on these agreements does entail some risks.** Cambodia, as a small-yet-open economy, is vulnerable to external shocks arising from global uncertainties. The escalation of the trade war and growing protectionism sentiments, for instance, could adversely impact Cambodia's GDP growth through second-round impacts on major export partners such as the E.U. and the U.S.

In addition, Cambodia's GSP agreement, specifically EBA, is subject to renewal every three years. Should there be any change to the status quo, for example, graduation to higher income economy status, unfavorable human rights conditions or political issues (Box B), Cambodia could lose the EBA status. The concern on the withdrawal of Cambodia's EBA status is now mounting after the European Commission recently published a blog post, highlighting its launch of a process for the withdrawal of Cambodia's EBA.[50] Losing EBA status is estimated to cost Cambodia not only a substantial amount of tariffs[51], but FDI inflows are also expected to decline, as EBA is one of the major factors in attracting FDI into Cambodia.

Moreover, the Vietnam – E.U. FTA, once successfully ratified, will become another major threat to Cambodia's exports to the E.U. The Ministry of Commerce's estimate suggests that Cambodia could lose 20 percent of its exports to the E.U. in two years' time after the

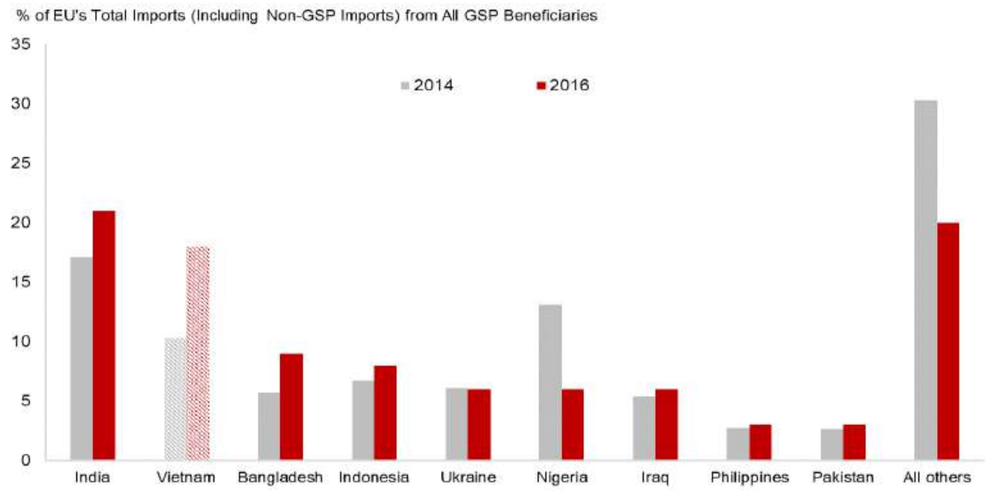
[50] Source: the European Commission's blog, on Myanmar and Cambodia by the Commissioner Cecilia Malmström, 5 October 2018.

[51] As cited in the Phnom Penh Post's news article "Kingdom's trade deal with EU questioned before poll" dated 11 July 2018, an estimate by Cambodia's Ministry of Commerce indicates that suspension of the EBA agreement would cost Cambodia USD676 million in tariffs (or 3.4 percent of GDP in 2016).

implementation of the Vietnam – E.U. FTA. In fact, Vietnam already has significant presence in E.U. market, and the FTA will give a major boost to its export to the E.U. Figure A3.7 shows that the second largest fraction of EU imports (including non-GSP imports) from all GSP beneficiary countries is from Vietnam, currently a Standard GSP beneficiary.[52]

Given these risks, Cambodia should step up its efforts to diversify both export products and destinations to reduce concentration risks, while trying to move up the value chain in its manufacturing sector and further upgrading the skills of its labor force to attract quality FDIs. In this regards, the authorities have introduced Technical and Vocational Training Policy 2017 – 2025 supported by establishing Skill Development Fund to provide adaptable workforce with professional skills through fostering role of the private sector in skills development.

Figure A3.7. Total EU Imports (Including Non-GSP Imports) from All GSP Beneficiaries



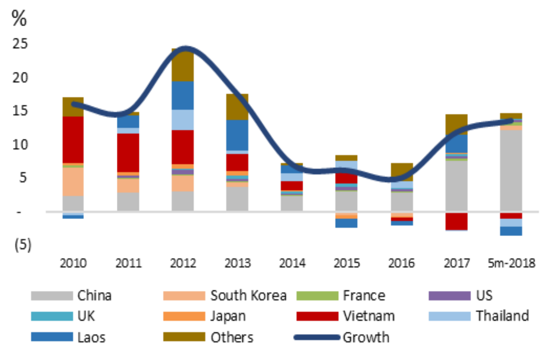
Note: The latest data is up to 2016
Source: European Commission

[52] Standard GSP reduces E.U. import duties for about 66 percent on all product tariff lines, and the Standard GSP as established by the current Regulation (978/2012) is valid until 2023.

Annex 4. The Development of Tourism in Cambodia

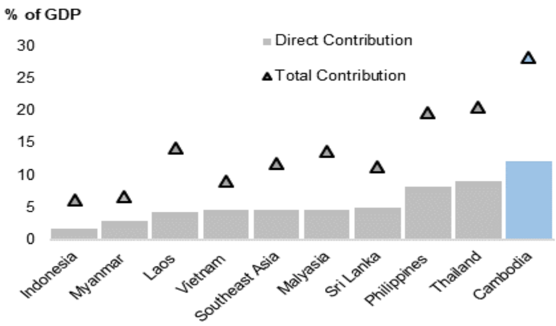
1. **Cambodia's tourism sector has been playing a critical role in sustaining economic growth and broadening the growth base.** The tourism-related services sector's share of GDP has been increasing in Cambodia, reaching around 40 percent by 2017. According to estimates from the World Travel & Tourism Council, Cambodian GDP exposure to tourism is the highest among the regional economies, both in terms of direct as well as indirect contributions. Given Cambodia's declining competitiveness in manufacturing exports and the rising uncertainty in maintaining preferential trade status, diversifying the economy to sustain the growth momentum is critical and the tourism sector has great potential.

Figure A4.1. Tourist Arrivals in Cambodia (Growth Decomposition)



Source: Ministry of Tourism

Figure A4.2. Contribution of Tourism to GDP[53]



Source: World Travel & Tourism Council 2018

2. **In particular, the number of Chinese tourists has been growing rapidly in recent years, but there is still a room for further increase.** In 2017, overall tourist arrivals grew by 12 percent reaching 5.6 million, of which China accounted for around 22 percent of arrivals, followed by Vietnam with 15 percent. Tourists from Laos and Thailand accounted for 9 percent and 7 percent of incoming tourist arrivals respectively. In the first half of 2018, China continued to be the biggest contributor with 31 percent of the tourist arrivals. On the other hand, for the 127 million Chinese outbound travellers, Thailand, Japan, South Korea and Singapore were the top destinations (excluding visits to Hong Kong and Macau), and Thailand alone recorded 10 million Chinese arrivals. Cambodia, meanwhile, received only 0.94 million tourists, less than 10 percent of the number of Chinese tourists who visited Thailand. Given the rapid growth in outbound tourism from China[54], Cambodia should look to attract more tourists to the country to help its transition to a more service-based and diversified economy. The "China Ready" strategy aims to attract two million Chinese tourists annually by 2020, up from the 1.6 million Chinese tourists expected for the whole year of 2018.[55]

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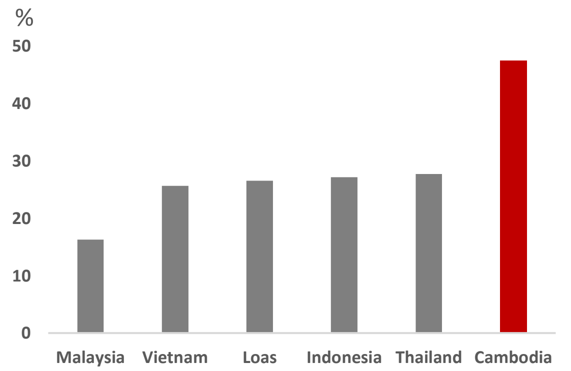
[53] Direct contribution reflects the total spending on this sector by residents and non-residents for business and leisure purposes and government spending on such services directly linked to visitors. The total contribution additionally includes indirect contribution (the GDP supported by this sector's investment, government spending helping travel and tourism activities, and domestic purchases by the sectors dealing with tourists) and induced contributions which measure GDP supported by the spending of those who are directly or indirectly employed in this sector.

[54] Between 2010 and 2016, the number of Chinese outbound tourists increased by 135 percent, and further growth is expected, and the number of outbound Chinese tourists is expected to reach more than 400 million by 2030, according to the China Outbound Tourism Research Institute.

[55] Initiatives include special arrival gates for Chinese tour groups with easy visa services, language training for tour guides, and the "China Ready" accreditaton system – which has provisions for food and beverages, accommodation, transportation, resorts,

3. **Against this backdrop, job creation in the tourism sector will likely remain strong, although high seasonal variations are expected to continue hampering skill development.** In 2017, the tourism sector employed 2.2 million people directly and indirectly. As Cambodia continues to attract more tourists, it is expected that there will be an additional 730,000 jobs created by 2027 to serve increasing demand.[56] While Cambodia is still young and has a relatively large labor pool to tap on, many of them lack necessary skills and are hired on a seasonal basis, in part due to the relatively high seasonal variations in tourist arrivals (Figure A4.3). Such a large fluctuation has also led to difficulties for businesses and reduces the incentive to both hire longer-term contract employees as well as to provide substantial training.

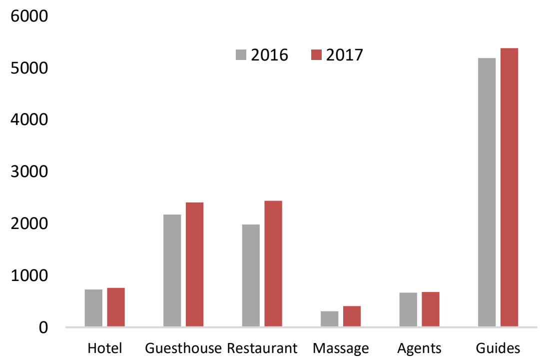
Figure A4.3. Seasonal Variation in Arrivals Between Low and High Seasons



Note: Variation of arrivals is the difference in the number of inbound tourists between low and high seasons, in percentage

Source: Respective tourism authorities, AMRO staff calculations

Figure A4.4. Tourism Related Supply



Source: Ministry of Tourism

4. **More public and private sector investments are needed to realize the country's untapped tourism potential.** The government has made efforts to improve physical and institutional infrastructure to attract more FDIs and tourists.[57] In addition to the adoption of the "China Ready" strategy, the Tourism Development Strategic Plan 2012-2020 has been put in place, which calls for enhancing tourism products, improving connectivity and visa facilitation, and raising tourism-related human capital.[58] Meanwhile, the demand for tourism services has attracted more investments in the sector. Foreign investment into the tourism sector —

shopping, entertainment and travel agents. By the end of 2017, 29 business institutes across the seven areas had been accredited as "China Ready".

[56] According to a World Travel & Tourism Council report, the travel and tourism sector contributed to 2.2 million jobs and accounted 26 percent of total employment in 2017. Of the 2.2 million jobs, 988,000 (about 11.4 percent of total overall employment) million were directly created by the sector. By 2027, it is expected that travel and tourism will account for 1,720,000 jobs directly.

[57] Total road network coverage has reached 55,000 km, out of which the National Road, connecting the capital to provinces where most of the tourist sites are located, comprises more than 20 percent. Besides, there is only one currently operational railroad from Phnom Penh to Sihanoukville, where Cambodia's deep-water seaport is based; and so the recent completion of the railroad from to Thailand via Poi Pet, is a welcome addition. In addition, construction for the expressway between Phnom Penh and Sihanoukville will start in late 2018, while the new Siem Reap International Airport, which aims to facilitate increasing tourist arrivals, is expected to see construction commence this year as well.

[58] For instance, an Open Sky policy has been implemented to increase connectivity between Cambodia and the regional aviation hubs. With the Open Sky policy, Cambodia has seen air capacity rapidly expanding from seven aircraft operated by two domestic airlines in 2013 to a total of 30 aircraft owned by seven domestic airlines as of H1 2018. International airlines have also dedicated more resources to this booming market, helping connect Cambodia with other countries and increasing connectivity within the country as well, with more than 260 flights per day.There are around 210 flights a day to and from Cambodia and 50 within Cambodia – of this number, 140 flights are to and from Phnom Penh Interantional Airport, 110 to and from Siem Reap and around 10 to and from Sihanoukville.

including in hotels, resorts, and casinos — for instance, grew at a rapid rate of 27 percent per annum in 2011-2017, reaching USD2 billion at the end of 2017. Many high-end hotels and resorts are presently under construction, particularly in Sihanoukville, and they are expected to be ready in the next few years. Together with local investment, FDIs in the sector have helped increase the supply of hospitality services.[59]

5. **While there have been rapid developments in the tourism-related sector, some challenges need to be addressed – these include ensuring sustainability, and inclusion, and tackling seasonality.** Overall tourist spending in Cambodia has remained low, estimated at about USD650 per arrival – significantly less than the USD1,420 in Thailand and the USD1,030 in Vietnam. This relatively low spending per head is a result of less diversified tourism products and sites, leading to shorter stays – an average of 6.8 days compared to 9.5 days in Thailand. Thus, improving the diversification of tourism products (including natural, historical, and cultural sites where Cambodia still has more potential to tap on) and transport infrastructure can help tourists spend more time and money in Cambodia. At the same time, developing indoor attractions and domestic tourism,[60] together with differential seasonal pricing, will not only ensure sustainability, but also reduce seasonal volatility in the sector. These endeavors could be supported further by providing more goods and services from both local SMEs and communities, such as "made-in-Cambodia" souvenirs, restaurants and farming experiences. This will result in the benefits of the growing tourism industry being passed on to a broader range of stakeholders in Cambodia.

[59] According to the authorities, the number of hospitality institutions has increased noticeably, to about 730 hotels with about 40,000 rooms, 2,405 guesthouses with 35,200 rooms, 2,440 restaurants, 410 massage centers, 682 travel agents and more than 5,000 licensed tour guides. At the same time, to ease traffic congestion, especially in Phnom Penh, the authorities have also increased city bus routes across the capital to 17 from 12 last year.

[60] According to the World Travel & Tourism Council, domestic spending contributes only around 16 percent of total tourism receipts. This illustrates that there is significant potential in the domestic market segment to tap on.