AMRO Country Report
ACR/22-10

AMRO Annual Consultation Report

Cambodia - 2022

ASEAN+3 Macroeconomic Research Office (AMRO)

December 2022

Acknowledgments

1. This Annual Consultation Report on Cambodia has been prepared in accordance with the functions of AMRO to monitor and assess the macroeconomic status and financial soundness of its members; identify relevant risks and vulnerabilities; report these to member authorities; and if requested, assist them in mitigating these risks through timely formulation of policy recommendations. This is being done in accordance with (Article 3 (a) and (b) of the AMRO Agreement).
2. This Report is drafted on the basis of the Annual Consultation Visit of AMRO to Cambodia from July 20 to August 3, 2022 (Article 5 (b) of the AMRO Agreement). The AMRO Mission team was headed by Dr Jinho Choi, Deputy Group Head and Senior Economist. Members include Mr Paolo Hernando, Desk Economist for Cambodia; Ms Vanne Khut, Economist; Dr Yoki Okawa, Economist; Ms Chunyu Yang, Associate Economist; Mr Tolakham Vann, Associate and Mr Monineath El, Associate. AMRO Chief Economist Dr Hoe Ee Khor also participated in key policy meetings with the authorities. This AMRO Annual Consultation Report on Cambodia for 2022 was peer reviewed by Dr Seung Hyun (Luke) Hong, Group Head and Lead Economist, and Dr Siang Leng Wong, Senior Financial Specialist, format-reviewed by Ms Vanne Khut, Economist, and approved by Dr Hoe Ee Khor, AMRO Chief Economist.
3. The analysis in this Report is based on information available up to September 15, 2022.
4. By making any designation of or reference to a particular territory or geographical area, or by using the term “member” or “country” in this Report, AMRO does not intend to make any judgments as to the legal or other status of any territory or area.
5. On behalf of AMRO, the Mission team wishes to thank the Cambodian authorities for their comments on this Report, as well as their excellent meeting arrangements and hospitality during our visit.

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Executive Summary

1. Cambodia's economy is projected to recover more strongly in 2022 on the back of robust external demand and a resumption in tourism and domestic activity. Sustained improvement in economic growth is expected as Cambodia continues to open up, supported by high vaccination rates. Despite the challenging outlook for the manufacturing sector due to the expected slowdown in the US and EU in the second half of 2022, GDP growth is projected to increase to 5.0 percent in 2022 from 3.0 percent in 2021, supported by the resumption of tourism and normalization of domestic activity.

2. Consumer price inflation has spiked in 2022, reflecting soaring global energy and food prices. Cambodia is highly reliant on imports of petroleum products which have spiked up in prices reflecting to a large extent the effects of the war in Ukraine. After averaging 6.6 percent in the first half of the year, inflation is expected to decline in the second half as global oil prices have come off its peak, and is forecast to average 5.3 percent in 2022.

3. The current account deficit is expected to narrow but remain high in 2022. Led by gold imports, the current account deficit widened to an unprecedented 45.7 percent of GDP in 2021, or 24.1 percent excluding gold. Building on the strong momentum of exports and steady recovery of tourism, the current account deficit is expected to narrow to 35.1 percent of GDP in 2022, or 21.9 percent of GDP excluding gold. FDI inflows into Cambodia are expected to remain stable. International reserves plateaued at USD19.5 billion as of June 2022 but remain ample at 9.3 months of imports of goods (excluding gold) and services.

4. Financial conditions remain easy with sufficient liquidity and strong credit growth. Liquidity is ample, as the National Bank of Cambodia (NBC) has taken several measures to ease liquidity conditions in the financial system. As a result, credit growth has remained resilient during the pandemic. As the economy is recovering steadily from the impact of the pandemic, the loan restructuring program was phased out as scheduled in June 2022. With capital adequacy ratios well above regulatory requirements, NPL ratios remaining low, and banks setting aside additional provisions from Q3 2021 onwards, bank balance sheets are expected to stay healthy even with the end of loan restructuring program.

5. The fiscal deficit is expected to narrow in 2022 due to higher revenue and the roll back of some pandemic related stimulus. Revenue has been buoyant in 2022 due to the resumption of economic activity. With most of the population already vaccinated and COVID-19 infections at a low level, health spending is budgeted to decline, while other key measures remain stable or are increased slightly, resulting in a stimulus package that is 1.4 percent of GDP smaller compared to last year. This gradual withdrawal of fiscal stimulus together with higher revenue collection are projected to lead to a narrower fiscal deficit of 5.4 percent of GDP in 2022.

6. External risks stem mainly from the expected slowdown in global growth. Headwinds from a slowing global demand amid the Russia-Ukraine war and monetary tightening in US and Europe, could impact on Cambodia's exports of manufacturing products. In addition, since Cambodia's export goods are priced in USD, a sharp appreciation of the USD may adversely affect their price competitiveness, particularly in Europe, which could further dampen demand. A sharper-than-expected economic downturn in China could also result in a moderation in FDI inflows to Cambodia, cause supply chain disruptions, and delay the recovery of Cambodia's tourism industry.

7. Sustained global energy inflation could erode living standards and stifle growth through the second-round effects. High global oil prices have contributed to the spike in inflation in

Cambodia as fuel prices are generally market determined, and changes in the global price are fully passed on to retail petrol prices. Given the high dependence on petroleum imports, soaring oil prices have weighed on household budgets. Heightened inflationary pressures could persist despite the easing of global oil prices in the second half of the year if price hikes spill over to other products, that may in turn result in restrained consumption, and set back poverty reduction, while increasing production costs for businesses.

8. Cambodia's large current account deficits are a source of external vulnerability. While the current account has registered sizable deficits in Cambodia prior to the pandemic, the deficit (excluding gold) has widened markedly since 2019. The large current account deficits have been financed mainly by FDI inflows and an increase in external liabilities. However, with large current account deficits, a large adverse shock to FDI inflows or substantial outflows from banks' non-resident deposits, could put great pressure on the external position in the absence of capital controls in a highly dollarized economy.

9. A sharp correction in property prices that lead to negative spillovers could affect the overall financial system through under-regulated real estate developers' financing. The country's rapid credit growth and credit-to-GDP ratio of 177 percent have given rise to concerns of financial distress, particularly in riskier segments of the economy such as real estate-related sectors and shadow banking. In particular, risks may have shifted away from banks towards shadow banking activities with the emergence of property developers that provide their own long-term financing with lax loan screening and minimal supervision. With little or no supervision, such shadow banking activities are more vulnerable to shocks, such as from a fall in property prices, which could propagate through the financial system.

10. Government should scale back the COVID-19 pandemic support programs in tandem with the economic recovery while providing targeted support to vulnerable groups most affected by the high inflation. With the pandemic waning in Cambodia, it is appropriate that the COVID-19 cash transfer program be redirected towards shielding the poor from the impact of high prices. However, the support program should be temporary with a clear sunset clause to avoid becoming entrenched. Going forward, a further strengthening of the social safety nets is highly encouraged.

11. The normalization of the NBC's liquidity measures and bank's provisioning for restructured loans should continue. Raising reserve requirements to pre-pandemic levels should be done in a calibrated manner in line with the economic recovery. With the end of regulatory forbearance on restructured loans, NBC should continue monitoring the quality of restructured loans, especially for those still under the assessment period, to ensure that enough provisions are set aside by banks. To reduce the risk of asset price bubbles, the authorities may consider introducing macroprudential measures such as ceilings on loan-to-value ratios, debt-service-to-income ratio, and sectoral risk weights.

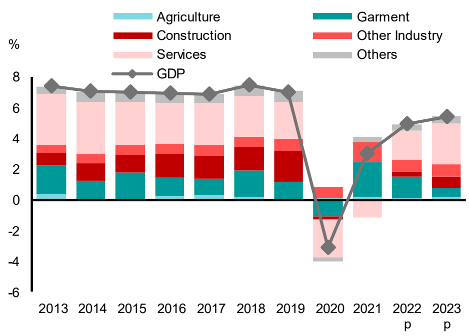
12. Continued and stronger focus on structural reforms is needed to maintain the growth momentum of the Cambodian economy. Boosting skilled labor supply to enhance productivity, augmenting infrastructure to reduce non-labor costs, and improving the institutional environment will all be critical in making Cambodia's business environment more competitive and attract more FDIs. As the economy develops, greater efforts should be made to develop domestic suppliers that feed into the manufacturing industries and encourage them to diversify and move up the production value chains. Fulfilling commitments to achieve carbon neutrality will also support long-term sustainability of the economy.

A. Recent Developments and Outlook

A.1 Real Sector Developments and Outlook

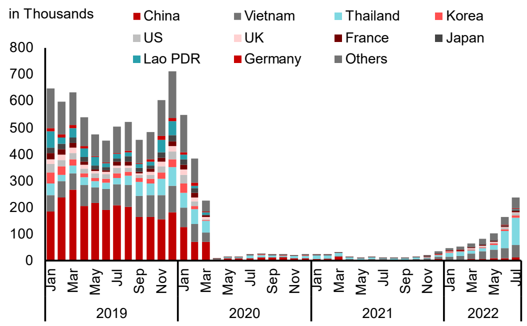
1. Cambodia's economy recovered markedly in the first half of 2022 on the back of strong external demand and a resumption in domestic activity. In 2021, Cambodia's economy was hit by a surge in COVID-19 infections which severely dampened domestic economic activity and derailed the nascent recovery from the downturn in 2020. However, the strong performance in the agriculture and manufacturing sectors kept GDP growth in positive territory last year, with the economy growing by 3.0 percent following a 3.1 percent contraction in 2020 (Figure 1). Labor market survey points to an estimated 330,000 tourism-related jobs lost or suspended at the peak of the pandemic, of which around 40 percent were able to find employment in other sectors.[1] In 2022, given the protection afforded by the country's high vaccination rates, the authorities have adopted a strategy of living with COVID-19 which has supported the recovery of the services sector during the first half of 2022. Although the number of international tourist arrivals remains below pre-pandemic levels, the promotion of domestic tourism has provided a much-needed boost. Meanwhile, the manufacturing sector was robust in the first half, with the value of both garment and non-garment manufactured exports growing by almost 40 percent.

Figure 1. Contribution to Real GDP Growth



Source: National Institute of Statistics (NIS); AMRO staff calculations
Note: p = projection

Figure 2. International Tourist Arrivals



Source: Ministry of Tourism (MOT)

2. Moving forward, the economy is expected to continue to track a gradual recovery path by growing 5.0 percent in 2022 and 5.4 percent in 2023. A sustained improvement in economic growth is expected as Cambodia continues to open up, supported by high vaccination rates. However, the outlook for the manufacturing sector will be more challenging as the US and EU, its two main export markets, are expected to slow down in the second half of 2022, and that could weigh heavily on the garment sector. This can be partially mitigated by the continued expansion of non-garment manufacturing, which now accounts for a tenth of total exports. FDI inflows into Cambodia are expected to remain stable, with the new Investment Law and recently signed FTAs[2] providing a good opportunity to attract investments into new areas and widen product reach to other export markets beyond the US and EU.

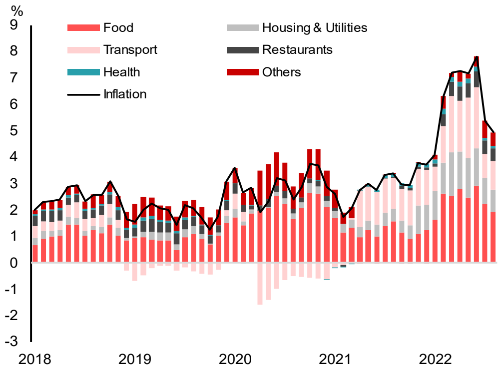
[1] Estimates from the Ministry of Labor and Vocational Training and Ministry of Tourism, of which most job losses or suspension were from the informal sector, as only around 10,000 tourism professionals officially registered for job loss in 2020. Around 50,000 suspended tourism professionals received wage subsidy in 2020. However, as of end-June 2022 only around 5,000 tourism professionals still receive wage subsidy, mostly from Siem Reap as its tourism industry was hardest hit by the pandemic.

[2] Cambodia's new Law on Investment was promulgated on October 15, 2021 with provisions that further strengthen the rights of investors and provide a variety of incentives, including new perks to encourage investors to build local supply chains. Meanwhile, the free trade agreement with China and Regional Comprehensive Economic Partnership (RCEP) entered into force at the start of the year, while that with Korea is expected to be ratified within the year.

Cambodia's tourism sector is growing rapidly from a low base, with arrivals in July 2022 breaching 200,000 tourists for the first time since the pandemic started, given its relatively open borders, although the pace of recovery is dependent on the global pandemic situation and reopening in source countries. However, in the short-term, international tourist arrivals are expected to remain far below pre-pandemic levels (Figure 2). Meanwhile, the construction and real estate sectors will remain weak, particularly as high-end projects that were stalled during the pandemic, have restarted at a slower pace amid uncertain foreign demand, although this could be partially offset by sustained demand for affordable housing. Amid the challenging environment, property prices according to NBC's Residential Property Price Index fell in consecutive months in May and June 2022 compared to a year earlier.

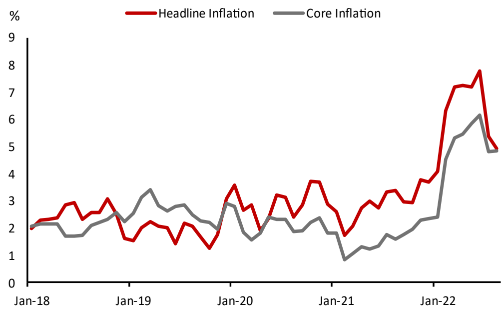
3. Consumer price inflation has spiked in 2022, reflecting soaring global energy and food prices. Cambodia is highly reliant on imports of petroleum products and is now importing them at much higher prices, reflecting to a large extent the effects of the war in Ukraine. The prices of electricity, gas and other fuels used by households, which account for 9.6 percent of the consumption basket, rose by 11.2 percent in the first half of 2022. Transport prices which has a 12.2 percent weight rose by 15 percent, driven by the 43 percent increase in fuel prices. Escalating global fertilizer prices and higher local transport costs have also made food more expensive, causing it to rise by 5.6 percent. The rise in food prices is acutely felt by the population as food accounts for 43.3 percent of the consumption basket. This has contributed to the spike in Consumer Price Index (CPI) inflation in Cambodia to 7.8 percent (yoy) in June 2022, the highest in 11 years (Figure 3). Higher prices of energy and food have already created upward price pressures on other products as well, with core inflation rising to 6.2 percent (Figure 4). After averaging 6.6 percent in the first half of the year, inflation has slowed to 5.4 and 4.9 percent in July and August, respectively, and it is seen to continue to decline in the second half as global oil prices have come off its peak. Thus, for the whole year, CPI inflation is forecast to average 5.3 percent, before coming down to 3.0 percent in 2023 due to base effects and continued fall in global oil prices (See Annex 1 "Drivers of Inflation Dynamics: The Case of Cambodia").

Figure 3. Contribution to Inflation (by Major Categories)



Source: NIS; AMRO staff calculations

Figure 4. Headline and Core Inflation

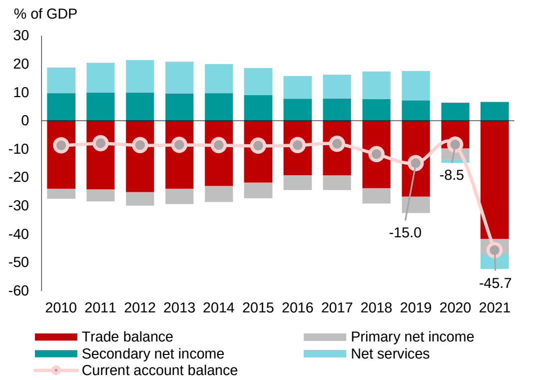


Source: NIS; AMRO staff calculations

A.2 External Sector and the Balance of Payments

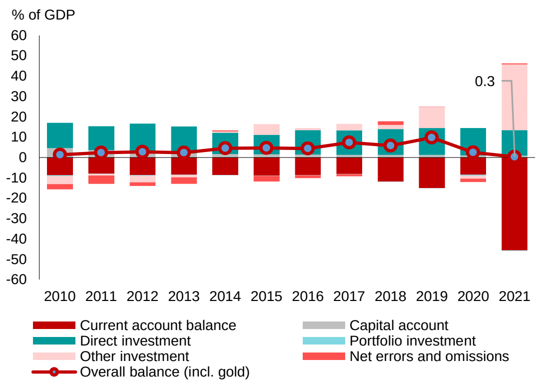
4. The current account deficit widened to an unprecedented 45.7 percent of GDP in 2021, largely due to a surge in gold imports. Imports rebounded strongly across most major items in line with the economic recovery. In addition, imports of non-monetary gold surged to USD5.9 billion in 2021 from USD864 million in 2020 (see Box A "Cambodia: The Pandemic and the Gold Trade). Meanwhile, net services fell anew due to the further decline of tourism. The combination of high imports and contraction of tourism receipts resulted in the current account deficit of 45.7 percent of GDP (Figure 5). Excluding gold, the current account deficit narrowed sharply but remained historically high at 24.1 percent of GDP, as imports outpaced exports . Overall, the balance of payments (BOP) was in a slight surplus in 2021 on account of continued FDI inflows, external borrowings, and a drawdown in offshore deposits (Figure 6).

Figure 5. Current Account Balance



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

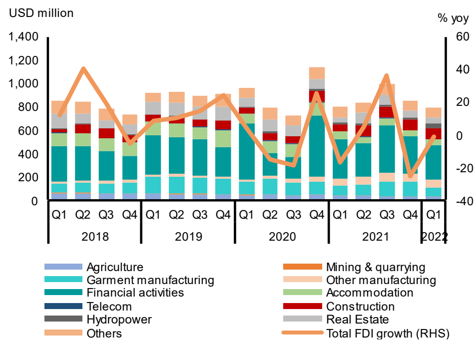
Figure 6. Balance of Payments



Source: NBC; AMRO staff calculations

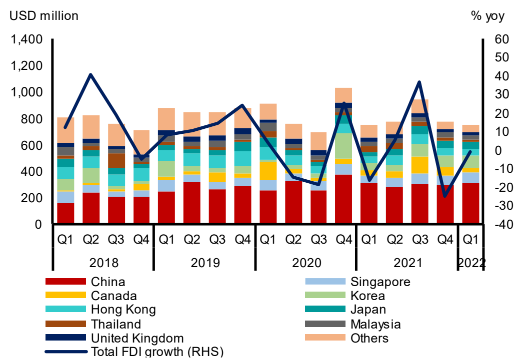
5. The current account deficit is seen to improve but remain high in 2022 at 35.1 percent of GDP. For 2022, exports grew rapidly by 37.7 percent in the first half, driven by garment exports. This slowed to 18.3 percent in July and abruptly dropped to 1.5 percent in August and is expected to remain sluggish for the rest of the year as the global economy slows down. Meanwhile, imports also increased across all major items led by petroleum, textile and construction materials. The import of gold remained substantial at USD4.2 billion in the first eight months of the year. The high imports, due in large part to elevated global prices of oil and other commodities, has resulted in a large trade deficit equivalent to 25.0 percent of GDP during the first eight months of 2022, albeit lower than the 27.1 percent deficit in the same period last year. For the whole year 2022, export is still seen to grow by double-digits, mostly due to the exemplary performance in the first half. However, the current account deficit (excluding gold) is expected to remain high at 21.9 percent of GDP in 2022 (or 35.1 percent including gold). FDI inflows has remained stable at USD801 million in Q1 2022 (Figure 7). FDI inflows from China have remained resilient despite its zero-COVID policy (Figure 8). International reserves plateaued at USD19.5 billion as of June 2022 but remained ample at 9.3 months of imports of goods (excluding gold) and services.

Figure 7. FDI Inflows by Sector



Source: NBC; AMRO staff calculations

Figure 8. FDI Inflows by Country



Source: NBC; AMRO staff calculations

Box A. Cambodia: The Pandemic and the Gold Trade [3]

Cambodia's trade statistics in 2020 and 2021 were distorted by large gold exports and imports. In 2020, COVID-19 restrictions caused a disruption in the production chain. Coupled with the fall in global demand, this resulted in a lower value of traditional exports from Cambodia, particularly garments.[4] However, gold exports jumped dramatically from USD388 million in 2019 to around USD3 billion in 2020. As a result, overall exports grew by 16.7 percent in 2020, similar to the 16.8 percent in 2019 (Figure A1). Gold exports contributed only about 2.6 percent to total exports before the pandemic, but the surge in 2020 increased its share of gold exports to 17.5 percent (equivalent to 11.6 percent of GDP). The surge in gold exports also helped narrow the current account deficit to 8.5 percent of GDP in 2020. However, this was reversed in 2021 when gold imports surged to almost USD6 billion from USD865 million in 2020 (Figure A2).

Imports decreased at the onset of the pandemic due to subdued economic activities but picked up significantly in 2021, driven by massive gold imports. Prior to 2020, more than a quarter of total imports were for materials used in the production of garments. Meanwhile, the import of gold was barely visible in the statistics in the past, with a share of around 2 percent of total imports on average from 2016 to 2019. In 2020, total imports decreased by 6 percent mainly due to lower imports of garment materials with the global demand for garments collapsing due to the pandemic, before increasing dramatically in 2021 thanks to substantial gold imports (20.7 percent of total imports). Consequently, with the surge in gold imports and the fall in gold exports to pre-pandemic levels, the current account deficit expanded tremendously to 45.7 percent of GDP in 2021 (Figure A3).

Various reasons have been provided for these developments:

- Sources suggest that one of the main reasons for the increase in gold exports and imports is speculative investments as gold prices increased significantly to USD1,968.6 per troy ounce in August 2020, followed by a decrease in 2021 (Figure A4). Furthermore, gold is considered as a popular investment and savings vehicle for Cambodian people.
- The improved ability to capture gold trading data due to stricter border controls as a result of COVID-19 is another factor in the higher gold trading numbers. Mirror trade data indicates that there have been large volumes of gold trading in Cambodia even prior to 2020, mainly with Singapore and Thailand (Figure A5 and A6).[5] These large flows were not recorded in Cambodia's official export statistics. However, stricter border controls may have enabled the capture of this trade in gold in official statistics, leading to a big jump in exports in 2020 and imports in 2021.

Appropriate adjustments need to be made to trade data in order to make a proper assessment of economic developments during 2019-2021. If gold is excluded, overall export growth slowed to 14 percent in 2019, contracted by 1.1 percent in 2020, and then grew by 22.8 percent in 2021 (Figure A1). This development is in line with economic trends as weaker external demand coupled with disruption in production led to a decrease in garment exports, the key export components, and hence a decrease in overall exports excluding gold in 2020. In 2021, the global economic recovery, resumption of domestic economic activities, and successful rollout of vaccination campaigns, boosted the country's exports, creating a V-shape recovery. On the import side, the movements also fit better with the economic condition when excluding gold. Total imports less gold grew by 19.8 percent in 2019, declined by 10 percent in 2020 and then grew by 26 percent in 2021 (Figure A2). The trend is supported by lower garment materials imports and weaker domestic demand at the beginning of the pandemic, followed by the rebound in imports reflecting the economic recovery in 2021. Reflecting underlying trade performance, the current account deficit (excluding gold) widened sharply to about 16 percent of GDP in both 2019 and 2020 before increasing further to 24 percent of GDP in 2021, in contrast to volatile movements under the official data, which indicate a strong improvement of the

[3] This box was prepared by Tolakham Vann, Associate.
[4] Garment exports were heavily affected by the pandemic. Garment products, which contributed more than 70 percent of total exports, decreased by 10 percent in 2020 (USD10.8 billion to USD9.8 billion).
[5] Exports of gold to Singapore recorded at USD2.2 billion and to Thailand at USD337 million in 2020. Meanwhile, gold imports from Singapore and Thailand into Cambodia average around USD3.2 billion per annum for the past six years. In 2021, Singapore exported about USD5.7 billion worth of gold to Cambodia while Thailand exported USD264 million worth of gold.

current account deficit to 8.5 percent of GDP in 2020, followed by a sharp deterioration to 45.7 percent of GDP in 2021 (Figure A3).

Figure A1. Cambodia's Exports

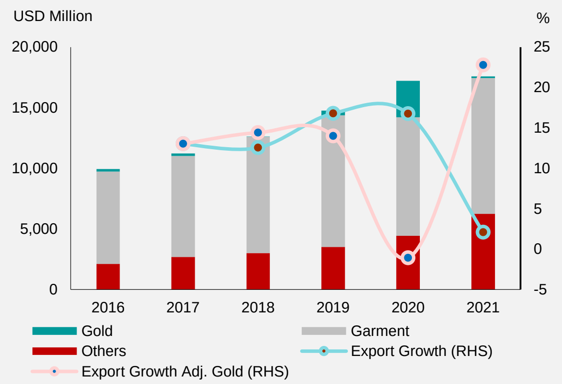
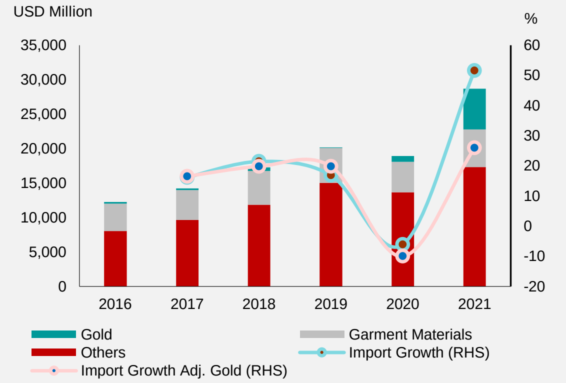
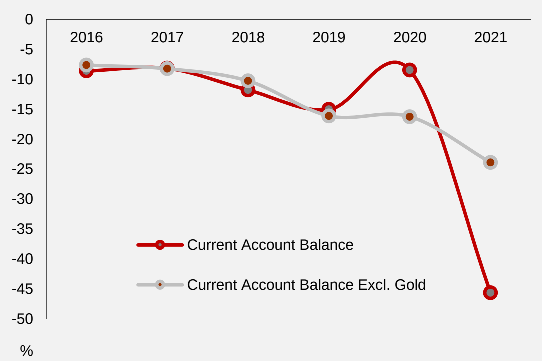


Figure A2. Cambodia's Imports



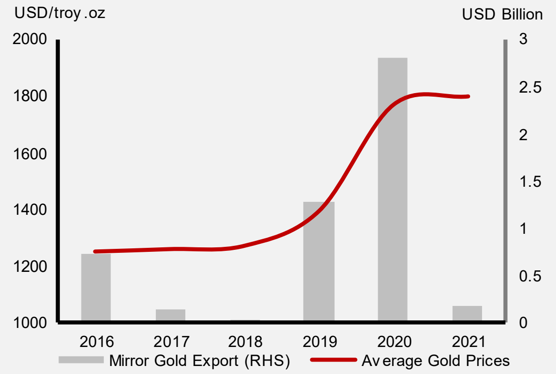
Source: Cambodia's General Department of Custom and Excise (GDCE); AMRO staff calculations

Figure A3. Current Account Balance
(As Percent of GDP)



Source: National Bank of Cambodia

Figure A4. Gold Price and Gold Export



Source: World Bank/Haver Analytics; Global Trade Atlas

Figure A5. Mirror and Official Exports

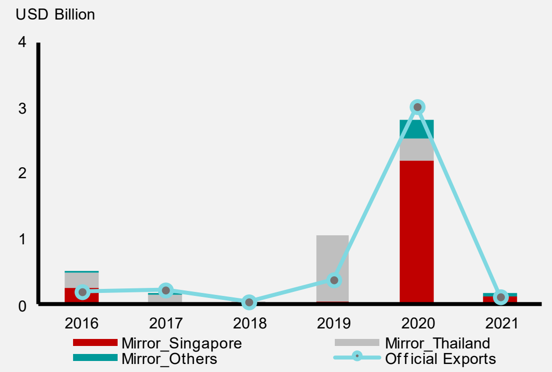
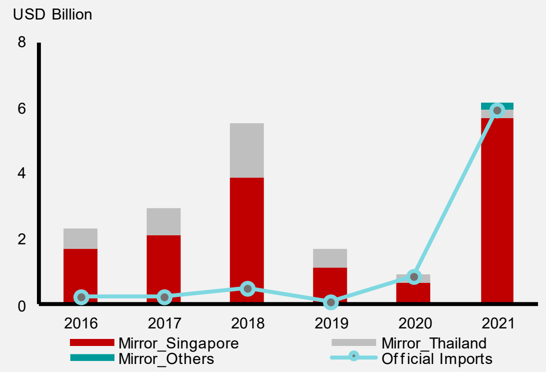


Figure A6. Mirror and Official Imports

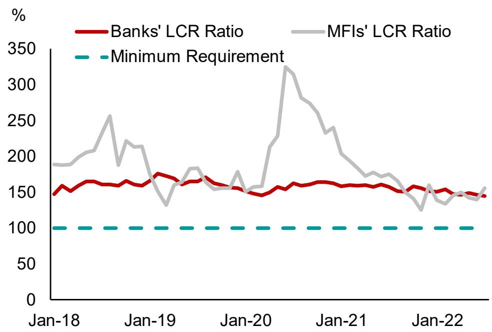


Source: Cambodia's GDCE; Global Trade Atlas

A.3 Monetary Condition and Financial Sector

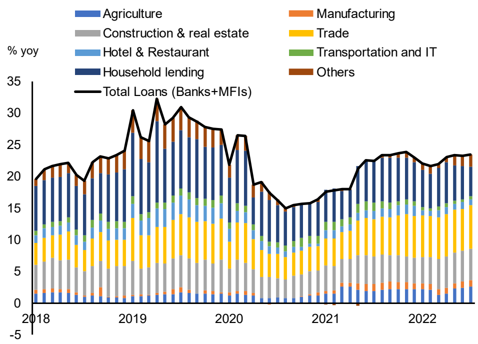
6. Financial conditions remain easy with sufficient liquidity and rapid credit growth. There is sufficient liquidity in the financial system, as the National Bank of Cambodia (NBC) has taken several measures to ease liquidity conditions in the financial system. With the liquidity coverage ratio of both banks and microfinance institutions (MFIs) at around 150 percent (Figure 9) and the excess reserves of banks remaining well above the reserve requirement, banks have sufficient funding capacity to support the recovery. This has led credit growth to remain resilient during the pandemic, growing above 20 percent (yoy) across a broad range of sectors (Figure 10). As a result, the credit-to-GDP ratio reached 177 percent in the first half of 2022, with the construction and real estate accounting for almost a fifth of total lending, followed by the wholesale and retail trade.

Figure 9. Liquidity Coverage Ratio (LCR)



Source: NBC; AMRO staff calculations

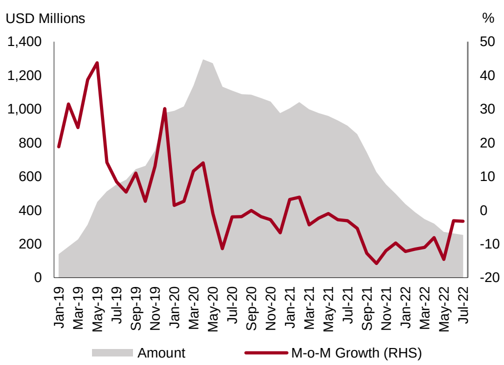
Figure 10. Loan Growth (Bank and MFIs)



Source: NBC; AMRO staff calculations

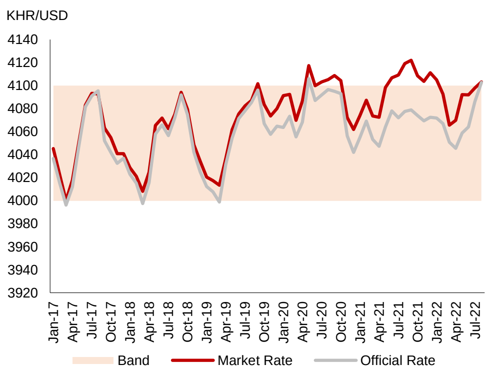
7. The NBC has tightened local currency liquidity, aiming to reduce depreciation pressures on the Khmer Riel (KHR). Accommodative measures by the NBC in the midst of the pandemic, particularly the cut in reserve requirement, unleashed significant KHR and USD liquidity into the market. The government's stimulus package has also added to the KHR liquidity in the system (see Box B "The NBC's Monetary Policy Response During the Pandemic"). As the economy recovers, the NBC withdrew KHR liquidity (Figure 11) while keeping stable the minimum interest rate of the Liquidity Providing Collateralized Operation (LPCO) to help keep the exchange rate stable. In addition to siphoning off KHR liquidity, the NBC intervened in the foreign exchange market by selling USD591.2 million to meet the demand for US dollar (Figure B2, Box B) and stave off depreciation pressures (Figure 12).

Figure 11. Outstanding LPCO



Source: NBC and AMRO staff calculations

Figure 12. Exchange Rate



Source: NBC and AMRO staff calculations

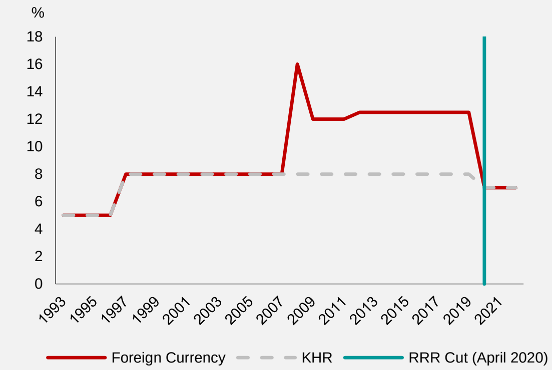
Box B. The NBC's Monetary Policy Response During the Pandemic[6]

The primary objective of the NBC's monetary policy[7] is to maintain price and exchange rate stability. Given the highly dollarized economy, the central bank's ability to set independent monetary policy and its role as the lender of the last resort are limited, and therefore monetary policy implementation has mainly focused on stabilizing the exchange rate against the USD. Nevertheless, the NBC has introduced several policy frameworks and instruments over the years to expand its ability to conduct monetary policy and gradually work toward a de-dollarization of the financial system that would not disrupt the macroeconomic stability in the country. The policy instruments include the reserve requirement ratio (RRR), foreign exchange (FX) intervention, negotiable certificate of deposit (NCD), liquidity-providing collateralized operation (LPCO) and the marginal lending facility (MLF).

During the COVID-19 pandemic, the NBC reduced the RRR to 7 percent for both local and foreign currencies to provide liquidity support to banking and financial institutions. Prior to the pandemic, RRRs were set at 8 percent for the local currency and at 12.5 percent for foreign currencies (Figure B1). During the pandemic, the RRR has been primarily used as a monetary tool to boost reserve money amid the economic slowdown and to safeguard against liquidity shocks in the banking system. The reserve requirements for both currencies bear no interest. The reduction of RRR during the pandemic immediately added about USD1.2 billion of liquidity to the banking system in April 2020. This liquidity support has been continued to provide banking and financial institutions with the ability to support economic activities in the recovery phase.

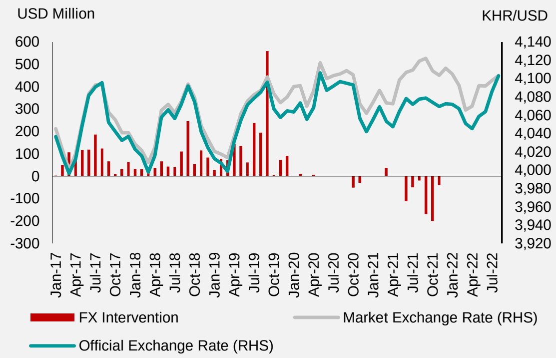
The NBC engaged in FX interventions using accumulated foreign reserves to manage the exchange rate during the pandemic. FX intervention is conducted through auctions and bilateral transactions with participation from financial institutions and licensed money changers. Prior to the pandemic, the NBC had been a net purchaser of USD, buying on average around USD1.2 billion per annum from 2017-2019. During the COVID-19 crisis, the massive amount of spending by the government to contain the spread of the pandemic and to help the vulnerable population and business sectors, coupled with lower capital inflows and the collapse of the tourism sector due to travel restrictions, put pressure on the exchange rate, leading to the depreciation of the KHR. In response, the NBC widened the gap between the official rate and the market rate to allow greater flexibility and intervened in the FX market by selling USD80.2 million in 2020 and USD591.2 million in 2021 to curb the pressure on the KHR (Figure B2). In August 2022, the NBC announced the readjustment of the official exchange rate[8] to reflect the market exchange rate by taking the weighted average of the exchange rates used in the interbank FX market on the NBC platform. The move is expected to allow for some more flexibility in exchange rate movement.

Figure B1. RRR



Source: NBC

Figure B2. FX Intervention



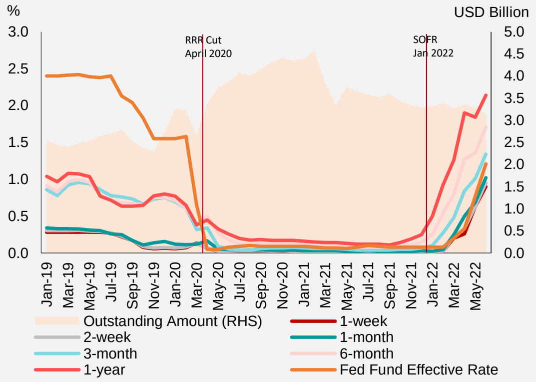
Source: NBC
Note: positive (negative) number means net purchase (sale) of USD.

[6] This box was prepared by Tolakham Vann, Associate.
[7] The NBC's monetary policy decisions are made by the Monetary Policy Committee chaired by the Governor of the central bank. The committee meets every two months to discuss recent economic and financial developments and decide the policy stance and direction.
[8] The official exchange rate serves as a reference rate to lead the market rate to the targeted level. When the NBC does not have a strong stance on the exchange rate level, the official exchange rate is allowed to be led by the market rate.

NCDs help banking and financial institutions manage their excess liquidity as well as contribute to the development of interbank market. The NBC issues NCDs as short-term-interest-bearing debt in two currencies: KHR and USD. NCD maturities range from seven days to a year with the reference rates[9] taken from Secured Overnight Financing Rate (SOFR). Banks can also sell the NCD back to the NBC with a small penalty. NCDs are tradable on the NBC Platform and have been used by financial institutions as collateral to access other facilities offered by the NBC. At the onset of the pandemic, interest rates on NCDs were reduced to encourage banks and other financial institutions to provide lending to the economy. With the change in reference rates to SOFR[10], the interest rates for NCDs have increased steadily (Figure B3). The amount of NCDs increased during 2020 due to excess liquidity and cautious lending by financial institutions, but it fell back down in 2021 as economic activities resumed and bank lending increased.

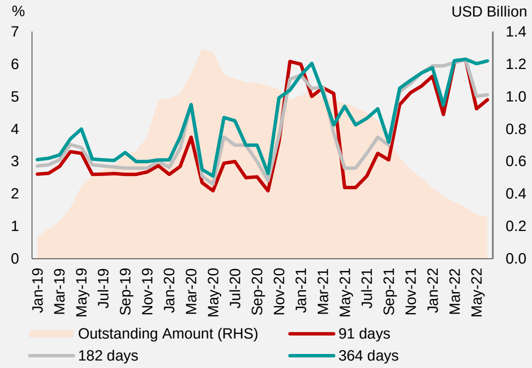
LPCO provides KHR liquidity for banks and microfinance institutions to finance the economy during the pandemic and the ensuing recovery. LPCOs are conducted through a Dutch auction that allows banks and microfinance institutions to bid for a certain amount of liquidity at a rate above the minimum interest rate for each maturity. LPCOs are collateralized by NCDs at a three-percent haircut for USD-denominated NCDs and are offered in three maturities: 91 days, 182 days and 364 days. As financial institutions are required to have at least 10 percent of their loan portfolio in KHR in an effort to curb dollarization, LPCOs have been a major source of local currency funding for those institutions to fulfill this requirement. At the initial stage of the pandemic, the NBC pre-emptively reduced the minimum interest rate by 0.5 percent for all maturities to support lower cost of funding in KHR for banks and microfinance institutions. The minimum interest rates[11] have been kept at the same level ever since, but the allotment amount has been reduced as the KHR liquidity released into the market has put pressure on the exchange rate. Therefore, the outstanding amount of LPCO has decreased sharply from its peak in April 2020. (Figure B4). LPCO rates are also increasing as banks and microfinance institutions compete to obtain the local currency liquidity.

Figure B3. USD-denominated NCD Rates and Outstanding Amount



Source: NBC

Figure B4. LPCO Rates and Outstanding Amount



Source: NBC

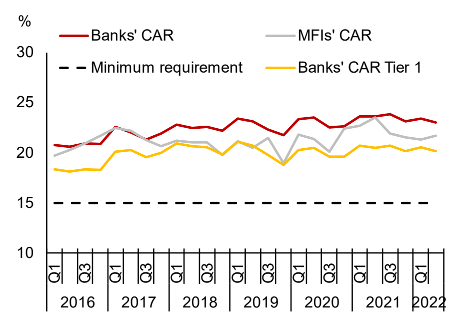
The MLF was introduced in September 2021 to provide short-term KHR liquidity to banks and microfinance institutions. The MLF[12] is an overnight advance collateralized with NCD at a certain haircut[13] and can be rolled over for up to five consecutive days. The interest rate for MLF is currently set at 4 percent. The benefits of MLF include providing short-term liquidity to financial institutions on demand, complementing the LPCO, but having less depreciation pressure on the KHR exchange rate due to its very short-term nature, and performing as a ceiling rate of the interest rate corridor system in the future. In the first half of 2022, KHR800 million was injected into financial institutions via the MLF.

[9] The NBC previously used the London Inter-Bank Offered Rate (LIBOR) to determine NCD rates.
[10] The change from LIBOR to SOFR is effective from 03 January 2022.
[11] The minimum interest rates are currently 2.1 percent for 3-month maturity, 2.3 percent for 6-month maturity and 2.5 percent for one-year maturity.
[12] MLF is requested through NBC Platform, and the amount is based on the value of collaterals.
[13] The haircut for NCD denominated in KHR is set at zero percent while the haircut for NCD denominated in USD is at 2 percent.

Further normalization of monetary policy is expected in the near future, and more policy instruments will be introduced to ensure a proper monetary policy framework and to mitigate risks associated with de-dollarization. As the economy recovers steadily, the NBC has been formulating an exit strategy to alleviate the side effects of monetary policy normalization, particularly for the RRR. In addition, plans have been made to introduce more policy instruments with the aim of establishing an interest rate corridor system, in which the MLF rate will act as the ceiling while another policy instrument called the Marginal Deposit Facility (MDF) will act as the floor. This system will enable the NBC to have some influence on market interest rates. The enhancement of the monetary policy framework will go hand-in-hand with efforts to curb and reduce dollarization.

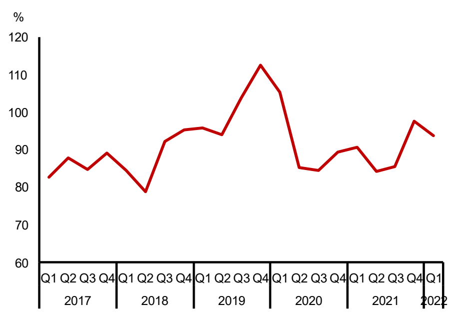
8. **Loan restructuring program was phased out as scheduled in June 2022 with no apparent adverse impact on financial stability so far.** In December 2021, the NBC issued a circular[14] for banks and financial institutions to review and classify their restructured loans and provide adequate provision before the expiry of the loan restructuring program in June 2022. Following the circular, banks and MFIs reported restructured loans were at KHR15.7 trillion or about 7.6 percent of total outstanding loans as of June 2022, down from 10.5 percent at the end of 2021. At the current juncture, about 6.3 percent of total restructured loans (equivalent to 0.5 percent of total loans) are considered non-viable. However, this figure may still rise as almost half of restructured loans are still being assessed on their correct classification and corresponding required provisioning. Capital adequacy ratios remain well above regulatory requirements (Figure 13), the NPL ratio has risen to 3.2 percent as of July 2022 but remains manageable, and banks have set aside additional provisions from Q3 2021 onwards (Figure 14). Therefore, bank balance sheets are expected to stay healthy even with the end of loan restructuring program (See Annex 2 “The Phasing Out of the Loan Restructuring Program and the Implication on the Banking Sector”). Additional regulations introduced before the pandemic such as liquidity coverage ratio and capital conservation buffer also proved useful in supporting financial sector soundness.

Figure 13. Capital Adequacy Ratio (CAR)



Source: NBC; AMRO staff calculations

Figure 14. Provision Coverage Ratio



Source: NBC; AMRO staff calculations

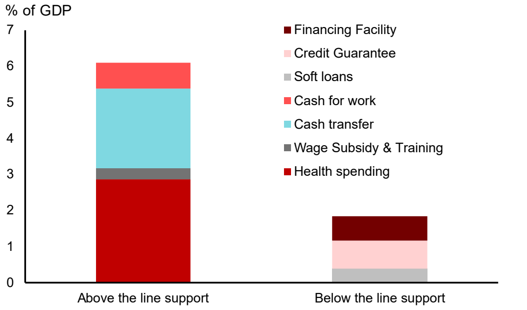
A.4 Fiscal Sector

9. **Fiscal policy supported the hard-hit sectors of the economy during the pandemic.** The government nearly doubled its COVID-19 intervention package in 2021 to USD1.3 billion (4.7 percent of GDP) and budgeted an additional USD989 million (3.3 percent of GDP) for 2022. Key fiscal support measures include cash transfer to the poor, wage subsidies and cash for work scheme, which helped support households through the pandemic. Meanwhile, a quarter of the package was allocated to support firms during the pandemic, and facilitate the post-pandemic economic recovery, mainly through targeted lending and guarantees to SMEs (Figure 15). The fiscal deficit widened to 8.5 percent of GDP in 2021 from 5.3 percent of GDP

[14] NBC Circular on Classification and Provisioning Requirement for Restructured Loans (Circular No. B7-021-2314).

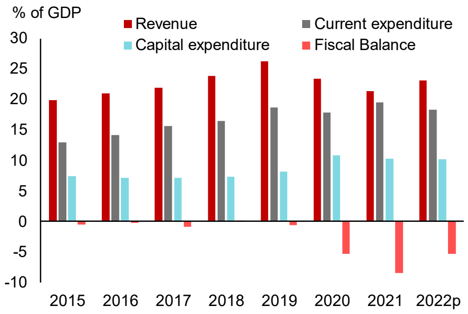
in 2020 (Figure 16), with bulk of the deficit financed from a drawdown in fiscal reserves. Public debt rose slightly to 35.0 percent of GDP as of end-2021, from 33.8 percent as of end-2020.

Figure 15. Fiscal Support 2020-2021



Source: Ministry of Economy and Finance (MEF); AMRO staff calculations

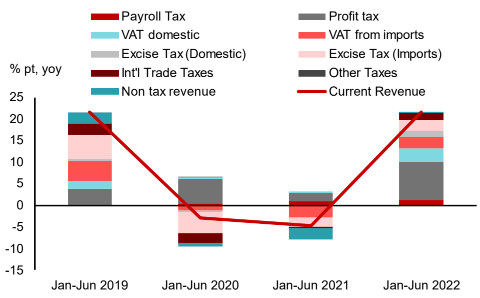
Figure 16. Fiscal Balance



Source: MEF; AMRO staff calculations
Note: p = projection

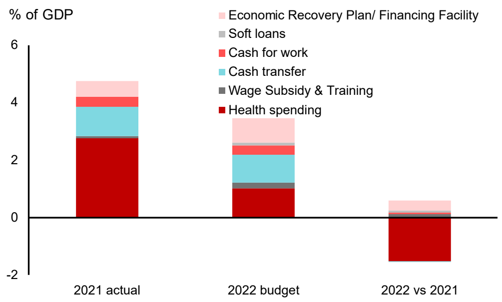
10. The fiscal deficit is expected to narrow in 2022 due to higher revenue and roll back of some pandemic related stimulus. For 2022, revenue has been buoyant due to the resumption of economic activity, with collection growing by 20 percent in the first half of 2022 (Figure 17). With most of the population already vaccinated and COVID-19 infections at a low level, health spending is budgeted to go down, while other key measures remain stable or are increased slightly, resulting in a stimulus package that is 1.4 percent of GDP smaller compared to last year (Figure 18). This gradual withdrawal of fiscal stimulus together with higher revenue collection are projected to lead to a narrower fiscal deficit of 5.4 percent of GDP in 2022.

Figure 17. Revenues



Source: MEF; AMRO staff calculations

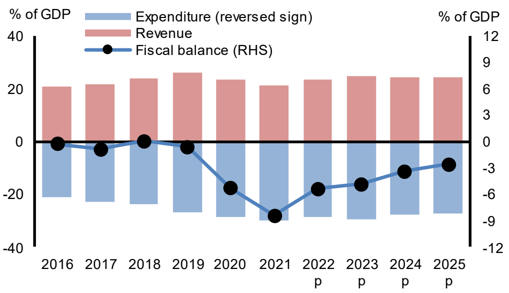
Figure 18. Unwinding of Fiscal Stimulus



Source: MEF; AMRO staff calculations

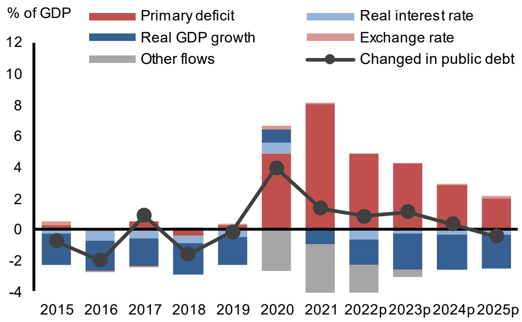
11. Public debt is projected to rise modestly over the medium-term with steady fiscal consolidation and improving growth prospects. The broad fiscal support measures that provided key support to economic recovery amid the pandemic also led to an increase in fiscal deficit and public debt. However, public debt has not risen as much as the expansion of the deficit because the government has drawn from its fiscal reserves. The fiscal deficit averaged 6.9 percent of GDP over the past two years or a cumulative deficit of 13.8 percent of GDP. Meanwhile, public debt has only risen by 6.9 percentage points to 35 percent of GDP at the end of 2021 from 28.1 percent of GDP at the end of 2019. Despite the projected reduction in the fiscal deficit this year, rising expenditure pressures next year from continuing efforts to support the recovery and shield the vulnerable from the impact of high inflation could put pressure on the fiscal position (Figure 19). However, with the expectation that revenue grows in line with the recovery, and capital expenditure reverting to pre-pandemic levels by 2024, public debt is projected to peak at around 37 percent of GDP in 2024, and start trending down by 2025 (Figure 20).

Figure 19. Medium-Term Fiscal Projection



Source: MEF; AMRO staff calculations
Note: p = projection

Figure 20. Debt Dynamics Projection

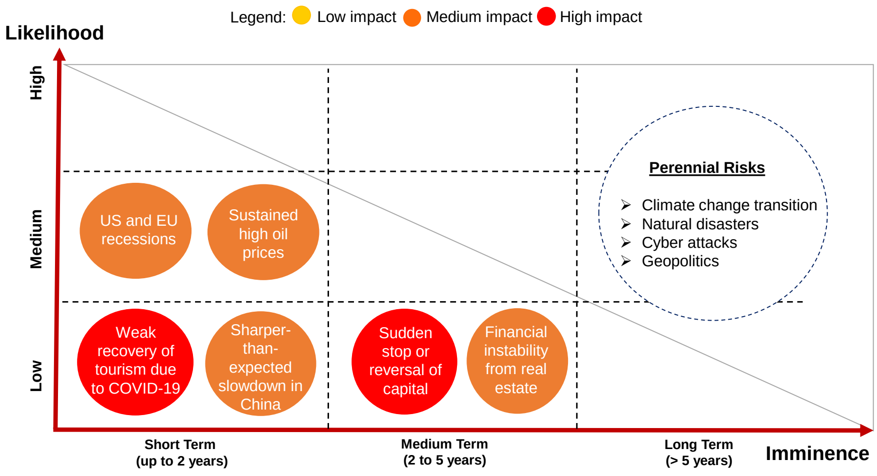


Source: MEF; AMRO staff calculations
Note: p = projection

B. Risks, Vulnerabilities and Challenges

12. The economy's trajectory towards a robust recovery is subject to rising domestic and external risks. As a highly open and dollarized economy, Cambodia is vulnerable to external shocks, including a sustained increase in energy prices, an economic slowdown in key trading partners, and global financial tightening. More virulent variants of COVID-19 may lead to tighter containment measures and delay a recovery of international tourism to the pre-pandemic level. Domestic vulnerabilities include high inflation, large current account deficits, and under-regulated shadow banking lending to the real estate sector.

Figure 21. Cambodia Risk Map



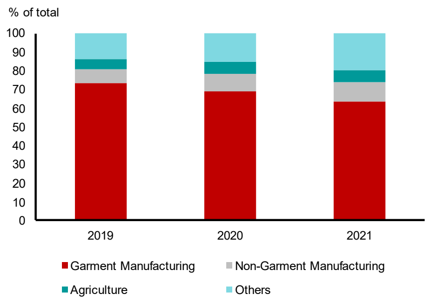
Source: AMRO staff assessment

B.1 Near-term Risks to the Macro Outlook

13. External risks stem mainly from the slowdown in key export markets. Headwinds from a slowing global demand amid the Russia-Ukraine war and monetary tightening in US and Europe could impact on Cambodia's exports of manufacturing products. Given Cambodia's high concentration in garment exports to the US and Europe, the export sector is vulnerable to demand shocks from these key markets (Figure 22 and 23). In addition, since

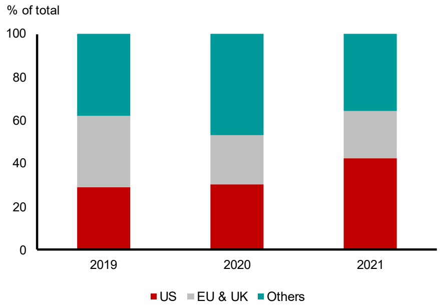
Cambodia's export goods are denominated in USD, a sharp appreciation of the USD may adversely affect their price competitiveness, particularly in Europe, which could further dampen demand. Uncertainty regarding the renewal of US Generalized System of Preference (GSP) could also dampen garment exports.

Figure 22. Export by Product



Source: AMRO staff calculations

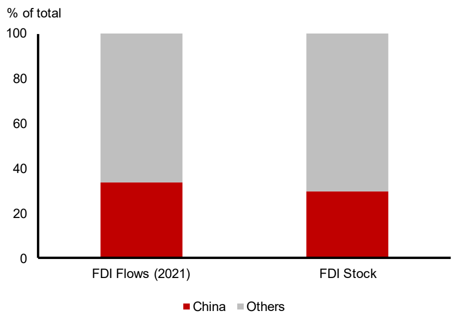
Figure 23. Export by Destination



Source: AMRO staff calculations

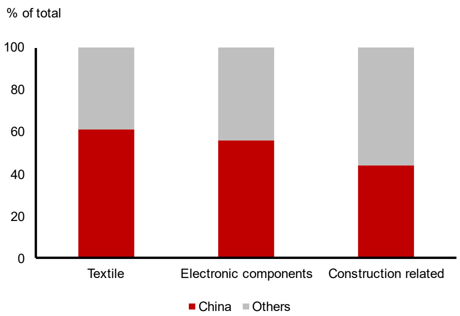
14. A sharper-than-expected economic slowdown and prolonged tight border controls in China could adversely affect Cambodia's growth prospects. China is the largest source of FDI inflows for Cambodia, accounting for around one third of total inflows (Figure 24). A sharper-than-expected economic downturn in China could result in a moderation in FDI inflows to Cambodia, especially inflows to the construction sector. Area lockdowns and tight border controls in China, as part of its efforts to manage the pandemic, may also cause supply chain disruptions. This could pose a challenge to Cambodia given that it relies heavily on China for intermediate goods, with more than 60 percent of textile inputs and 44 percent of construction related materials sourced from China (Figure 25). Prolonged border controls in China will also delay the recovery of Cambodia's tourism industry since more than a third of all foreign tourists prior to the pandemic were from China.

Figure 24. Foreign Direct Investments



Source: AMRO staff calculations

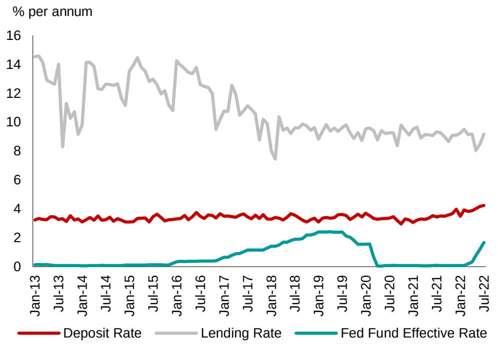
Figure 25. Imports of Intermediate Goods (2019-2021)



Source: AMRO staff calculations

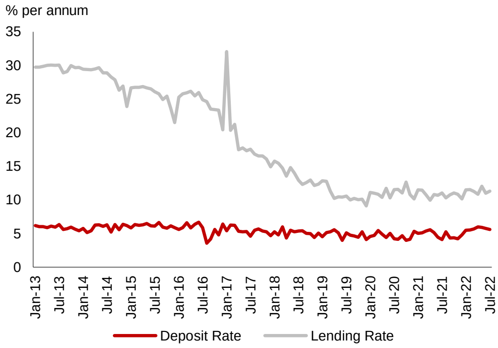
15. The impact of US Fed's aggressive rate hikes on Cambodia is assessed to be minimal, mainly due to its relatively low linkages to the global financial markets. Despite the high degree of dollarization, Cambodia's domestic interest rates were not responsive to US rate hikes during the previous Fed tightening cycles. A similar situation applies in the current period, wherein domestic USD and KHR interest rates have remained relatively stable amid US Fed rate hikes (Figure 26 and 27). Interest rates for USD lending and deposit in Cambodia are much higher than those in the US and are more responsive to domestic economic conditions and monetary measures taken by the NBC. The risk of capital outflows from portfolio investment is also unlikely for Cambodia in the short-term, as financial markets in Cambodia are not well developed and less connected to global financial markets; instead, foreign capital inflows comprise mainly of FDI inflows and concessional loans from MDBs and official donors.

Figure 26. USD Interest Rates



Source: NBC and AMRO staff calculations

Figure 27. KHR Interest Rates



Source: NBC and AMRO staff calculations

16. Cambodia's tourism recovery remains vulnerable to the risk of resurgence in COVID-19 infections. Despite its high vaccination rate and upgraded health system since the onset of the pandemic, the risk of a massive outbreak from new and more virulent variants remains, which could lead to renewed lockdowns and derail the economic recovery, especially of tourism. Given the critical role that tourism plays for various businesses and jobs in Cambodia, further delay in the resumption of international travel is a key risk for the growth outlook.

17. Sustained rise in global energy prices could erode living standards and stifle growth through the second-round effects. Global oil prices breached USD100 per barrel with the start of the Russia-Ukraine war. This has contributed to the spike in inflation in Cambodia as fuel prices are generally market determined, and changes in the global price are fully passed on to the retail petrol prices. Higher oil prices have exerted inflationary pressures, resulting in increases in prices of other goods, especially food. Given the high dependence on petroleum imports, soaring oil prices have weighed on household budgets. Despite the recent easing of inflationary pressures in Cambodia, continued vigilance is needed as there are still significant upside risks to oil prices arising from geopolitical tensions and supply constraints. Although inflation has slowed, the overall price level remains elevated compared to a year ago, that could spur calls for higher wages in the future. However, the risk that heightened inflation expectations could lead to rapid wage growth is low in Cambodia, given the rapidly growing labor force and slack in the labor market during the pandemic.[15]

Authorities' Views

18. ***The NBC viewed that inflationary pressures have been managed well through their efforts to control the money supply and ensure a stable exchange rate.*** *Through these efforts, inflation has gone down in line with the fall in oil prices, with the high inflation episode during the first half of 2022 expected to have little or no impact on the cost of doing business going forward.*

[15] The population growth rate of 1.5 percent added 1.6 million to the labor force between 2009 to 2019/2020 and ILO estimates indicate that hours worked fell by 4.8 and 6.8 percent in 2020 and 2021 respectively, compared to the pre-pandemic level.

B.2 Longer-term Challenges and Vulnerabilities

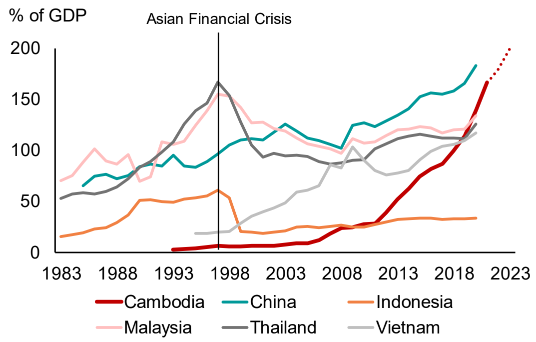
19. Cambodia's large current account deficits are a potential source of external vulnerability. While the current account has registered a sizable deficit in Cambodia prior to the pandemic, the deficit (excluding gold) has widened markedly since 2019. This reflects a number of factors including large imports of construction materials since 2019, the collapse in tourism and lower remittances since 2020, and imports of vaccines and medical supplies, and high oil prices since 2021. The large current account deficit has been financed mainly by FDI inflows and external borrowing. However, with large current account deficits, a large adverse shock to FDI inflows or substantial capital outflows from banks' non-resident deposits, could put great pressure on the external position, especially in a highly dollarized economy with no capital controls (See Annex 3 "Long-term Costs of Financing Current Account Deficits").

20. A marked drawdown of government savings and significant increases in contingent liabilities during the COVID-19 pandemic have reduced fiscal space. With government savings drawn down to help finance the stimulus budget, the amount of fiscal reserves has declined by more than a third compared to the pre-pandemic level. This may limit the government's capacity to provide counter-cyclical support in the event of another large shock. The reduction in fiscal revenues relative to pre-pandemic trends has also made it more challenging to rebuild fiscal buffers. Moreover, USD 280 million of soft loans and USD 57 million credit guarantee (equivalent to 1.1 percent of GDP) provided by government institutions to SMEs since the pandemic, are a source of contingent liability that needs to be managed well, particularly as another USD 250 million soft loans are planned for 2022.[16]

21. A sharp correction in property prices could have negative spillovers on the overall financial system through under-regulated real estate developers' financing. With banks' CAR at over 20 percent, it is well above the NBC's regulatory requirement of 15 percent. However, the country's steep credit growth and resulting high credit-to-GDP ratio (Figure 28 and 29) has given rise to concerns of financial distress in some segments of the economy such as real estate-related sectors and shadow banking. In particular, risks may have shifted away from banks and towards shadow banking activities with the emergence of property developers that provide their own long-term financing with lax loan screening and minimal supervision. During the first half of 2022, loan installments to the real estate developers accounted for USD 157 million, equivalent to 35 percent of the total payment due, according to preliminary data from the Non-Bank Financial Services Authority (NBFSA). With little or no supervision, such shadow banking activities are more vulnerable to shocks, such as from a fall in property prices, which could propagate through the financial system. However, a sharp fall in property prices that is large enough to adversely affect the financial sector is considered a tail risk for the time being, with the economy on the path to recovery, interest rates remaining stable and credit growth robust.

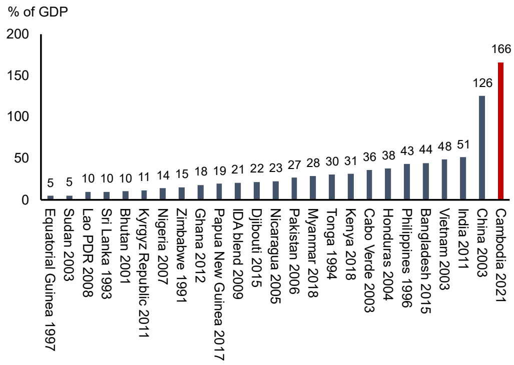
[16] Lending has been mainly done through the government-owned SME Bank and Agriculture and Rural Development Bank (ARDB) and guarantees through the Credit Guarantee Corporation of Cambodia.

Figure 28. Domestic Credit



Source: CEIC; AMRO staff calculations
Note: Domestic Credit to the banking sector. Dotted line is based on AMRO forecast of 2022 and 2023.

Figure 29. Credit for the countries with similar GDP per capita to Cambodia 2021



Source: World Bank
Note: Year and credit when countries' GDP per capita in 2017 PPP exceeds $4262, Cambodia's 2021 level. Samples are from the World Bank's World Development Indicator Database.

Authorities' Views

22. ***The NBC viewed that external vulnerability may persist if Cambodia's current account deficits remain large.*** *The economy has been hit by several shocks, particularly the COVID-19 pandemic and high commodity prices, which have increased imports and disrupted tourism. These shocks on top of idiosyncratic imports of gold have caused the current account deficit to widen significantly. However, the NBC expects the current account deficit to narrow progressively along with the recovery of the tourism sector and workers' remittance and return to pre-pandemic level within the next 5 years.*

C. Policy Discussions and Recommendations

C.1 Continuing Targeted Support while Rebuilding Fiscal Buffers

23. Government should scale back the COVID-19 pandemic support programs in tandem with the economic recovery while providing targeted support to vulnerable groups most affected by the high inflation. The decisive policy responses including the cash transfer, wage subsidy, and cash for work scheme have helped minimize economic scarring and averted vulnerable households from falling into poverty. Government savings have been drawn down by almost USD2 billion in the past two years to help finance the COVID-19 stimulus package, with another drawdown of around USD170 million expected in 2022. With the fiscal buffer narrowing, the pandemic waning, and the economy recovering, the various emergency support measures for businesses and households should be scaled back based on a review of program relevance and effectiveness. However, the current high inflation has hit the vulnerable group severely. As the pandemic wanes in Cambodia, it is appropriate that the COVID-19 cash transfer program be redirected towards shielding the poor from the effects of high inflation. Targeted cash transfers would prove more efficient than fuel subsidies that could disproportionately support higher income households who consume more fuel. The expansion of the existing cash transfer program to the "nearly-poor" group in addition to the “poor” is a timely move to relieve soaring costs of living amid high inflation.[17] However, the support program should be temporary with a clear sunset clause to avoid from becoming entrenched. Going forward, further strengthening of social safety nets are highly encouraged. In this regard, the government’s plan to transform the cash transfer into a broad social protection program to help improve health, education and living standards among the poor and vulnerable is commendable.

24. Rebuilding revenues after the disruption from the pandemic and streamlining fiscal incentives are needed to help preserve fiscal space. A careful evaluation of the new challenges facing the economy will be needed to help the country forge a path in the post-pandemic era. Lessons from the ongoing assessment of the tax system reform, as well as the mid-term review of the Revenue Mobilization Strategy (RMS) 2019-2023 should restart the momentum for the next round of tax reforms. The government should be on track to implement the delayed capital gains tax by 2024. In line with the planned implementation of capital gains tax, fundamental reforms on personal income tax should be initiated to enhance simplicity and support the appropriate sharing of tax burden by broadening the tax base and enhancing progressivity. The streamlining of fiscal incentives can also help rebuild fiscal space. To strengthen monitoring, the government will need to implement a system to track tax expenditures, which will support the transparent assessment on the cost and benefits of providing fiscal incentives. As the country develops and moves into middle income status, it will be graduated from access to grants and concessional loans and will have to rely more on commercial borrowing. The government should accelerate the development of the government bond market which will allow more flexibility to finance its long-term infrastructure investment.

25. From a longer-term perspective, fiscal policy needs to focus on enhancing the growth potential of the economy. A well designed and coordinated 3-year rolling Public Investment Plan is essential to enhance Cambodia’s long-term growth potential. Revenues should also be steadily enhanced to provide a reliable source of funds for development. Fiscal policy should continue to support policy priorities such as strengthening infrastructure, digital connectivity, and green growth. A well-planned fiscal support to education and vocational training will enable the economy to move up the manufacturing value chain as well as to upgrade the service sectors. Support for the tourism sector should include retaining core tourism services, development of new tourism attractions, and ensuring connectivity among the various attractions. Enhanced budget execution and monitoring in line with Medium-Term Fiscal Framework and Public Financial Management (PFM) reform will be crucial to ensure that limited resources are directed to these growth-enhancing priorities of the government. The expansion of lending facilities for SMEs and provision of credit guarantees also need to ensure that such credits are channeled to productive sectors and risks from contingent liabilities are well managed.

C.2 Monetary Policy Normalization and Exchange Rate Stability

26. The normalization of the NBC’s liquidity measures should continue, in line with the economic recovery. The current accommodative liquidity settings reflect NBC’s efforts to support the recovery. With the recovery in progress, NBC will need to closely monitor possible spillovers that could lead to risky lending or exchange rate pressure. Thus, the normalization of the NBC’s liquidity measures should be carefully calibrated in line with the economic

[17] Beneficiaries of the cash transfer program are identified through a proxy means test survey, wherein household characteristics are used to develop a statistical model to estimate household income and consumption. Based on the Cambodia Socio-Economic Survey for 2019/20, the national poverty rate is KHR10,951 per person per day, accounting for about 18 percent of the population. Although the formal definition of nearly-poor has yet to be set by the government, the goal is to mitigate the probability of those in the second lowest quintile of income from falling into poverty.

recovery, particularly by raising reserve requirements to pre-pandemic levels.[18] Adjustments to the amount of issuance of NBC's main monetary instruments should help smoothen the normalization process.

27. A stable exchange rate provides an anchor against external shocks to the highly dollarized economy. In view of the high level of dollarization, the NBC should continue to maintain exchange rate stability to help mitigate inflationary pressures as well as to sustain investor confidence. Enhanced policy coordination between the monetary and fiscal authorities is also essential to ensure that fiscal stimulus does not put pressure on the exchange rate. Going forward, coordination will be even more crucial with the launch of the domestic bond market, wherein the timing and size of debt issuances will have an impact on government cash balances and liquidity forecasting of the central bank.

28. From the long-term perspective, gradual de-dollarization efforts should be continued to wean the economy off its dollar dependence and strengthen the monetary autonomy. Although dollarization combined with a stable exchange rate has resulted in manageable inflation, over the long-term, the increased public confidence in the local currency should support its greater adoption, with the goal of gradual de-dollarization.[19] Furthermore, as the "impossible trinity" dictates that a country cannot have monetary autonomy while having a fixed exchange rate regime and free capital mobility, the central bank will have to gradually adjust the flexibility of its exchange rate in the long run to support the monetary policy implementation.

C.3 Safeguarding Financial Stability

29. Continued enhancement of supervision and strengthening of risk management will help maintain financial sector stability. With the end of regulatory forbearance on restructured loans, efforts by the NBC to review and classify them with the objective of ensuring adequate provisioning are commendable. The NBC should continue monitoring the quality of restructured loans, especially for those still under the assessment period, to help ensure that provisions set aside by banks are adequate.[20] The capital conservation buffer could also be raised in phases until the BIS requirement of 2.5 percent is attained. Meanwhile, the NBC is encouraged to continue conducting random offsite inspections in addition to the current risk-based method, as well as increasing the frequency of inspections. To reduce the risk of asset price bubbles, authorities may consider introducing macroprudential measures such as ceilings on loan-to-value ratios, debt-service-to-income ratio, and sectoral risk weights. The establishment of the Non-Bank Financial Services Authority is a welcome move for better regulation and supervision of shadow banking. The efforts to establish solid regulatory and supervisory framework together with improving data collection should continue. The regulatory authorities should encourage the credit bureau to expand its coverage to all types of financing, including loans from real estate developers.

C.4 Structural Reforms for Post-Pandemic Era

30. Development of local suppliers through technology transfer and skill upgrading is essential to move up the value chain. As the economy develops, greater efforts should be

[18] This is especially relevant for the reserve requirement for foreign exchange, which was cut from 12.5 percent to 7 percent, providing NBC with more policy space to gradually tighten. Although the reserve requirement for local currency can likewise be normalized gradually, there is less space to maneuver since it was only cut by 1 percentage point (from 8 to 7 percent).
[19] Efforts to enhance greater KHR usage include improvements in the KHR payment system, setting a minimum threshold of lending in KHR of at least 10 percent of bank loan portfolios, calling back small US dollar notes to raise KHR circulation in the economy and prior to the pandemic lower reserve requirement for KHR relative to foreign currencies, among others.
[20] Provision coverage ratio during the pandemic of between 80-90 percent remain below the pre-pandemic level of 113 percent, with provisions for restructured loans as a share of total restructured loans only at 8.3 percent as of May 2022 (See Annex 2).

made to champion domestic suppliers that feed into the manufacturing industries and encourage them to diversify and move up the production value chain. This will enable Cambodian companies to supply multinational coroporations (MNCs) in the future, and create local manufacturing clusters that have deep interlinkages with the global value chain. To help achieve this, Cambodia should boost skilled labor supply to enhance productivity, augment infrastructure to reduce non-labor costs, and facilitate technology transfer to move up the value chain. Cambodia should also continually improve the institutional and regulatory framework, to help make the business environment more competitive and attractive to foreign investors. In this regard, the promulgation of the new Investment Law and the greater market access through recently agreed bilateral free trade agreements (FTAs) with China and Korea, and the Regional Comprehensive Economic Partnership (RCEP) provides an additional boost for supply chains to be located in the country. The establishment of the SME bank and the Skill Development Fund in the past few years is a great stepping-stone to promote growth in domestic production and supply, and raise productivity of the labor force.

31. Continued and stronger focus on structural reforms is needed to maintain the growth momentum of the Cambodian economy. Given rising labor costs and the country's goal of attaining high-middle-income status, strong policy commitment, continuity and consistency will help ensure needed reforms are implemented to enhance competitiveness and move up the global value chain. The need to improve competitiveness and diversify the economy is put into sharper focus with the pending graduation of Cambodia from the United Nations' least developed country (LDC) status in 2027, which will lead to the loss of preferential trade privileges from 2030. Continued policy support for long-term development issues will also help enhance the resilience of the economy in the post pandemic period, by improving labor productivity, enhancing social safety net and public health, as well as implementing climate change mitigation and adaptation measures (See Box C "Government's Structural Policy Initiatives During the Pandemic").

32. Fulfilling commitments to achieve carbon neutrality will support long-term sustainability of the economy. Policies to achieve net zero emissions by 2050 to mitigate the impact of climate change under the Paris Agreement and to ease the transition for different sectors of the economy will have to be carefully crafted. Energy plans for development should be carefully balanced against the need to meet climate change commitments. In this regard, Cambodia's Long-Term Strategy for Carbon Neutrality is commendable. Continued monitoring and updating of this plan will be needed to successfully shift towards renewable energy. As the shift towards a green economy will entail substantial public investment, financing plans need to take account of the impact of climate change measures on tax collection and the need for new sources of revenue, as well as actively tapping green finance.

Box C. Government's Structural Policy Initiatives During the Pandemic[21]

Cambodian government seized the opportunities arising from the pandemic to address structural issues to revitalize economic growth and strengthen socio-economic resilience. The government launched "the Strategic Framework and Programs for Economic Recovery in the Context of Living with COVID-19 in a New Normal 2021-2023" in December 2021, with the aim of reviving key sectors of the economy; promoting structural reform for growth, diversification, and competitiveness; strengthening resilience; and achieving macro-economic stability. In particular, the development of the strategic framework and programs applies the three pillars (or 3Rs) including Recovery, Reform, and Resilience (Table C1) and utilizes policy instruments (fiscal, monetary, and macro-prudential policy) and financing mechanisms (Revenue Mobilization Strategy[22], Government

[21] This box was prepared by Monineath EL, Associate.
[22] The Revenue Mobilization Strategy 2019-2023 was launched in 2019 with the aim of modernizing the tax revenue system and strengthening non-tax revenue administration and policy.

Bond[23], and Public-Private Partnership Mechanisms[24]) as means to support the implementation. To achieve its goals, the government has rolled out policy initiatives focused on key priorities including the Digital Economy and Society Policy Framework; the Law on Investment; Garment, Footwear, and Travel Goods Development Strategies; and the Social Security Pension Scheme as well as Green Development.

Table C1. Three Pillars of Strategic Framework and Program for Economic Recovery

Three Pillars (3Rs)		Key Priorities
Pillar 1- Recovery	Stimulating the growth of key pre-crisis-sectors to return to the growth path while further promoting potential sectors.	- Agriculture and agro-industry - Tourism sector - Garment sector - Non-garment sector
Pillar 2- Reform	Continuing to introduce key structural reform measures to improve the environment and trade facilitation for investments and businesses.	- Regional free trade agreement - Law on investment - Electricity sector - Ease of doing business - Transportation and logistics sectors
Pillar 3 - Resilience	Strengthening readiness and response to ensure the sustainability and inclusiveness of socio-economic development, as well as to cope with similar diseases or crises that may erupt in the future.	- Digital sector - SME and skill development - Education and health sector - Social protection system - Climate change adaptation - Green development

Source: Ministry of Economy and Finance

The government launched the "Cambodia Digital Economy and Society Policy Framework 2021-2035" to embrace digital transformation and foster digital sector development. The 15-year framework sets out a long-term vision to build a vibrant digital economy and society and pinpoints five major priorities including developing digital infrastructure, building reliability and confidence in digital systems, building digital citizens, building the digital government, and promoting digital businesses. Recognizing the leading role of government in the creation of an inclusive digital economy and society, the "Digital Government Policy 2022-2035" was formulated in 2022 to support the implementation of the framework**.** The policy aims to build a smart government based on utilizing digital infrastructure and technology to modernize the governance system and reform in a transparent and reliable manner. Against this backdrop, the government launched the Cambodia Data Exchange (CamDX)[25] Platform, which adopted Estonia's X-Road[26], to support multi-lateral data exchange among 14 registered government agencies. In addition, the first government portal of a unified business registration procedure "Online Business Registration[27]", has been created to make doing business easier in Cambodia. Moving forward, the policy framework will establish foundations for promoting digital adoption and transformation in all dimensions of society to promote new economic growth and improve social welfare in the new normal.

The Law on Investment (LoI) is promulgated to bring a new legal framework conducive to foreign and domestic investments. The LoI establishes an open, transparent, and predictable legal framework to attract and promote quality, effective and efficient investments. Additionally, the LoI grants guarantees to investors and provides project-based investment incentives[28] to lure investment in 19 priority sectors, including high-tech and innovative industries, agriculture, SMEs, tourism, SEZs, health, education, digital industries, physical infrastructure, logistics, green energy, etc. Specifically, generous investment incentives (Table C2), utilizing both profit-based and cost-based incentives, are likely to attract higher-tech efficiency-seeking FDI that will create higher value

[23] The government bond is planned to issue in the national currency, equivalent to approximately USD300 million under the 2022 Law on Financial Management.
[24] A Public-Private Partnership ("PPP") mechanism has been implemented under the Law on Public and Private Partnership that was enacted in November 2021 with the aims of promoting the management and implementation of PPP projects in an effective, efficient, sustainable, transparent, and accountable manner.
[25] CamDX, which is promulgated by Sub-decree No.164 dated August 2021, is a unified yet decentralized data exchange layer between information systems that offers a standardized and secure way to provide and consume services.
[26] X-Road, the backbone of e-Estonia, is a software-based solution that allows the nation's various public and private sector e-service information systems to link up and function in harmony.
[27] Online Business Registration was launched by sub-decree 84 dated June 2021 to allow investors to register for business licenses with relevant government agencies at an online one-stop service.
[28] The investment incentive under the LoI grants on a project basis is classified into "Qualified Investment Projects" (QIPs), "Expanded Qualified Investment Projects" (EQIPs), and "Guaranteed Investment Projects" (GIPs) registered with the Council for the Development of Cambodia or Municipal-Provincial Investment Sub-Committees.

added to the economy. Going forward, the new law should contribute to enhancing the country's competitiveness and attractiveness by diversifying the economic base, supporting innovation, and fostering economic recovery.

Table C2. Investment Incentive Scheme Under the Law on Investment

Basic incentives	Additional incentives	Special incentives
<u>Option 1:</u> ***Tax on Income exemption (3 to 9 years) after which a company will pay only 25 percent of income tax due for 2 years, 50 percent for the next 2 years, and 75 percent for the last 2 years.*** - Prepayment tax and minimum tax exemption and export tax exemption. - Exemption on customs duty, special tax, and VAT for relevant QIPs on import of construction material and equipment, production equipment, production inputs, etc.	-VAT exemption for the purchase of local content, - Deduction of 150 percent for activities of innovation, R&D, human resource development, etc. -Income tax exemption for the Expansion of QIP.	Any specific sector and investment activities that contribute to development may receive specific special incentives to be set out in the Law on Financial Management.
<u>Option 2:</u> ***Special depreciation rate (deduction up to 200 percent of specific expenses for up to 9 years)*** - Prepayment tax & minimum tax exemption and export tax exemption. - Exemption on customs duty, special tax, and VAT for the relevant QIPs on import of construction material and equipment, production equipment, production inputs, etc.		

Source: Council for the Development of Cambodia

The Cambodia Garment, Footwear, and Travel Goods (GFT) Sector Development Strategy 2022-2027 was unveiled in March 2022 to lift the country's backbone sector to the next level. The GFT sector has been a cornerstone of the Cambodian economy with its share of total exports exceeding 70 percent and has generated jobs for approximately 830,000 workers as well as provided indirect support to about 3 million Cambodians in the pre-pandemic. Nevertheless, the changes in regional and global economic landscape in the post-pandemic period call for a new outlook for the county's main sectors, thus the government implemented the six-year development strategy to transform Cambodia's GFT sector into a unique, competitive, high-value-add, resilient, and environmentally sustainable sector that represents a fundamental pillar of economic diversification. In particular, the strategy will address the sector's weaknesses through productivity and skill improvement, higher value-add enhancement, attracting investments, and export market diversification. In this regard, the strategy should shed light on the development direction for relevant stakeholders aiming at enhancing the sector's competitiveness as well as spurring the growth of the sectors both in the short and long term.

The social security pension scheme[29] has been expanded to the private sector which will be implemented in October 2022. The government originally planned to implement the pension scheme in 2019 following the promulgation of the Law on Social Security Scheme[30], but this was postponed due to the pandemic. The pension scheme, which will be operated under the National Social Security Fund, reflects the government's commitment to expanding the scope of social security from occupational risks and health care schemes. In addition, the pension scheme will provide old age benefits, invalidity benefits, and survivors' benefits as well as funeral allowance. To be eligible for the benefits, an employee must have registered for the pension scheme, be at least 60 years old, and contribute to the pension scheme for at least 12 months, failing which they will receive only an old-age allowance. In particular, the pension scheme's contribution rate will be conducted under three phases: i) the first phase with 4 percent for five years, ii) the second phase with 8 percent for another five years, and iii) the third phase with subsequent increases of 2.75 percent every ten years. The launch of an expanded social security pension scheme is assessed as a key milestone to strengthen financial protection for all elderly Cambodian citizens and serve as the social policy response to future demographic change.

[29] The pension scheme was introduced by Sub-Decree No. 32 dated 4 March 2021 governing the social security pension scheme for all persons covered under the Cambodian labor law, and Sub-Decree No.144 dated 19 August 2021 on the determination of contributory wage.
[30] The Law on Social Security Scheme was adopted on 2 November 2019 to define common principles, procedures, mechanisms, and administration system of social security schemes of the Kingdom of Cambodia such as Pension, Health Care, Occupational Risk, and Unemployment Schemes.

Cambodia has been aiming for green growth by introducing the National Green Growth Roadmap, the National Policy on Green Growth, and the National Strategic Plan on Green Growth (2013-2030). The plan is envisaged to develop a sustainable economy, together with environmental, social, and cultural sustainability by rolling out strategic directions[31] for relevant ministries and institutions to incorporate into their action plans. Against this backdrop, the government's economic recovery plan also incorporated green development as a priority with the focus on continuing to encourage investment in public infrastructure that is resilient to climate change; encouraging public and private investment in renewable energy and energy efficiency; providing incentives for green financing and continuing to promote sustainable production and consumption, etc. Moving forward, the plan will serve as the development path toward green growth to achieve a sustainable and resilient economy and demonstrate the government's commitment to the Paris Agreement on Climate Change.[32]

The success of implementing structural policy to build a more resilient economy rests upon the public sector's capacity. Further strengthening of public administration and fiscal governance should be continued. In particular, decentralization and de-concentration (D&D) reforms, which aim to improve public service delivery, should ensure the efficiency of resource allocation of funding and human resources across the different levels of government to achieve a well-functioning public administration. Similarly, the continuation of ongoing reforms in fiscal governance including public financial management, procurement, and investment should focus on improving transparency, spending efficiency, and monitoring frameworks.

31 The strategic directions mainly focus on green investment and green job creation; green economy management in balance with the environment; sustainable blue economy development; green environment and natural resources management; human resource development and green education; effective green technology management; promotion of green social safety system; protection of green cultural heritage and national identity; good governance on green growth

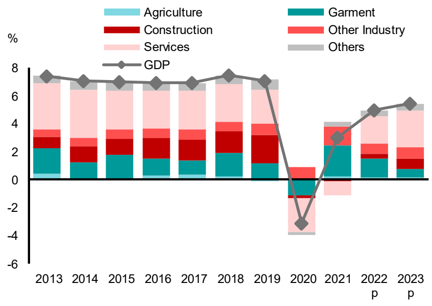
32 The Paris Agreement was adopted on 12 December 2015 and aims to limit global warming to well under 2 degrees Celsius.

Appendices

Appendix 1. Selected Figures for Major Economic Indicators

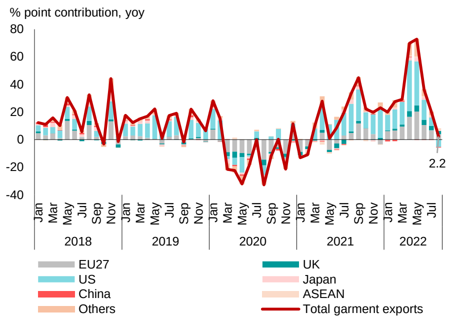
Figure 1.1. Real Sector

The economy will gradually recover in 2022 amid steady reopening after a surge in COVID-19 last year.



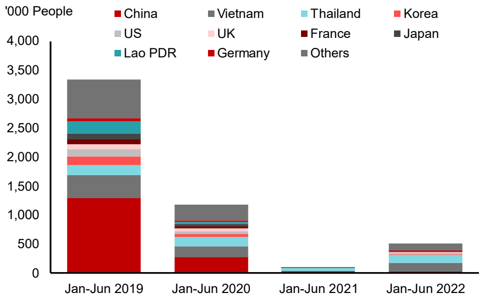
Source: NIS; AMRO staff calculations.

After contracting in 2020, garment exports have been a strong driver of the recovery until the first half of 2022.



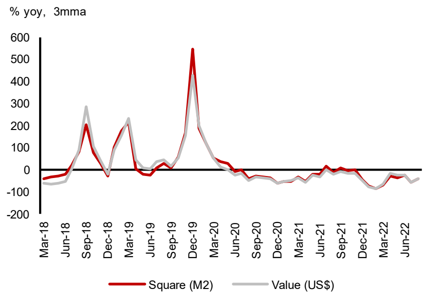
Source: GDCE; AMRO staff calculations.

Tourists have started to return but remain well below the pre-pandemic level.



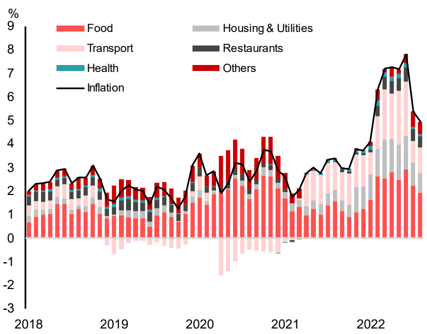
Source: Ministry of Tourism

Construction activity remains subdued as approvals for new projects continued to shrink.



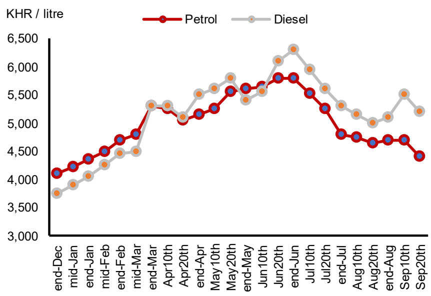
Source: Ministry of Land Management, Urban Planning and Construction; AMRO staff calculations.

Inflation has risen significantly in the first half of 2022 driven by rising energy prices and has slowed in the second half.



Source: NIS; AMRO staff calculations.

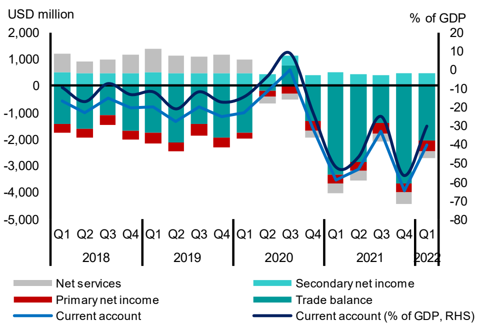
Falling retail prices of petroleum in the 2nd half of 2022 is expected to continue to help ease inflation.



Source: MEF; AMRO staff calculations.
Note: From April 2022 onwards, retail prices have been adjusted 3 time a month (every 10th, 20th and last day of the month).

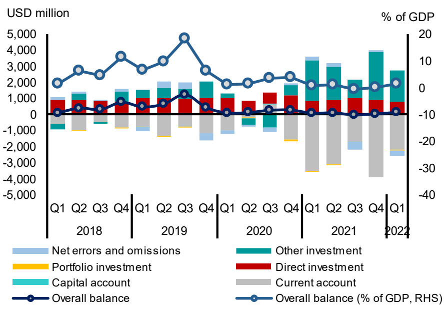
Figure 1.2. External Sector

After deteriorating for most of 2021, the current account deficit narrowed in Q1 2022, mainly due to an improvement in the trade deficit.



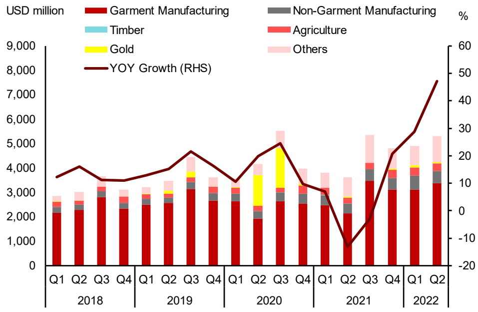
Source: NBC; AMRO staff calculations.

The overall balance of payments remained in surplus in Q1 2022, as FDI and other investments remain sufficient to fund the current account deficit.



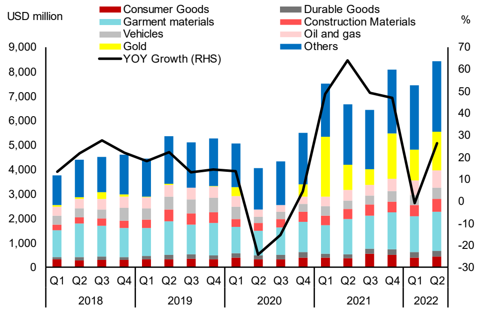
Source: NBC; AMRO staff calculations.

Export growth so far in 2022 has been strong driven by garment exports, and some base effects from the lockdown last year.



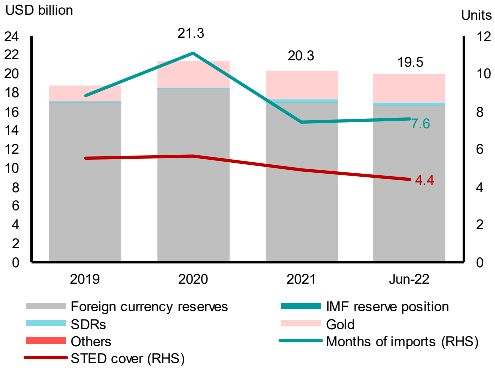
Source: NBC; AMRO staff calculations

Import growth has slowed down from 2021, in part due to lower gold imports, but remain high.



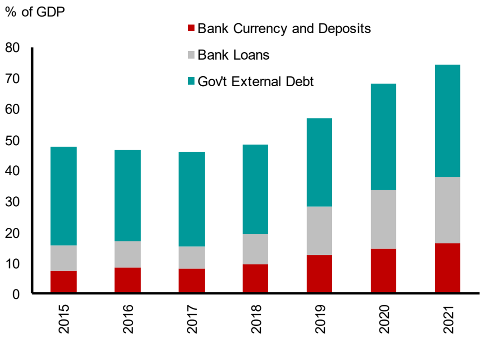
Source: NBC; AMRO staff calculations.

Cambodia's GIR remained high but dropped to USD19.5 billion as of June 2022 from 20.3 billion in 2021.



Source: NBC; AMRO staff calculations.

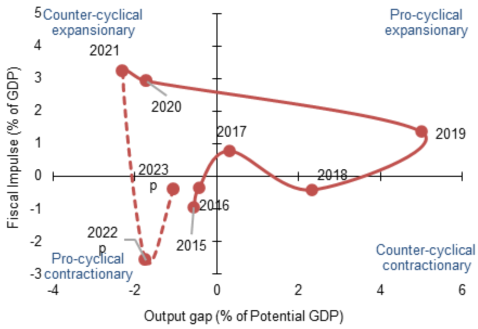
External debt has increased markedly in the past three years to 74.4 percent of GDP in 2021 from below 50 percent in 2018.



Source: NBC; AMRO staff calculations.

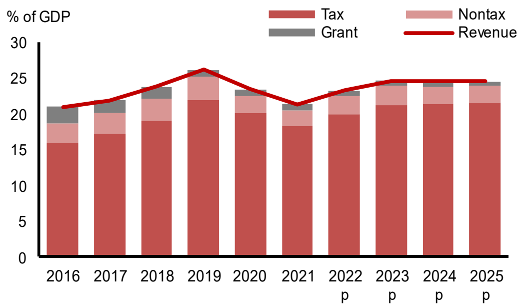
Figure 1.3. Fiscal Sector

As the pandemic wanes, fiscal policy is set to tighten as government ramps up revenue efforts and scales back fiscal stimulus.



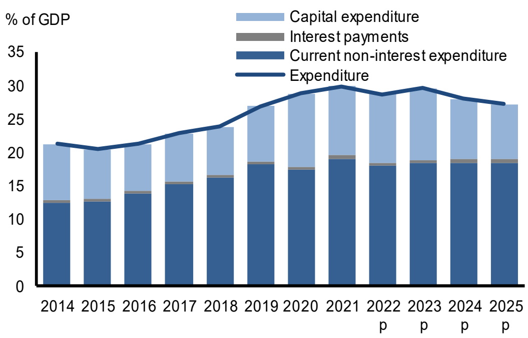
Source: MEF; AMRO staff calculations

Revenue is expected to keep pace with GDP growth over the medium-term.



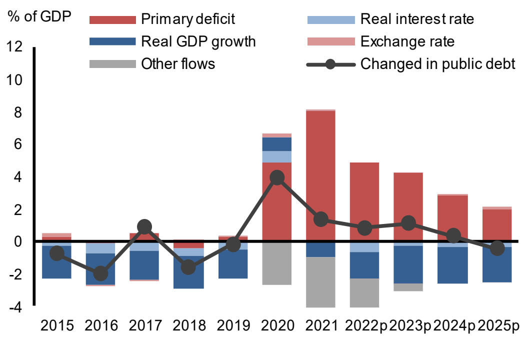
Source: MEF; AMRO staff calculations

Fiscal consolidation is projected to bring down the expenditure over the medium-term.



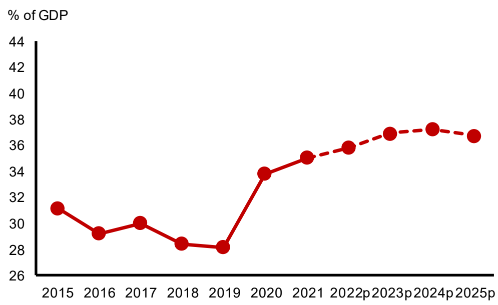
Source: MEF; AMRO staff calculations

Steady fiscal consolidation and improving growth prospects point to sustainable debt dynamics over the medium term.



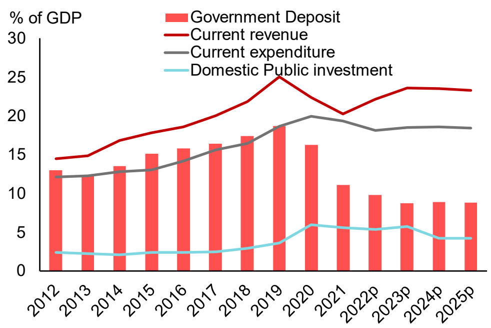
Source: MEF; AMRO staff calculations

Public debt is expected to remain low, rising slightly over the next two years before decreasing in 2025.



Source: MEF; AMRO staff calculations

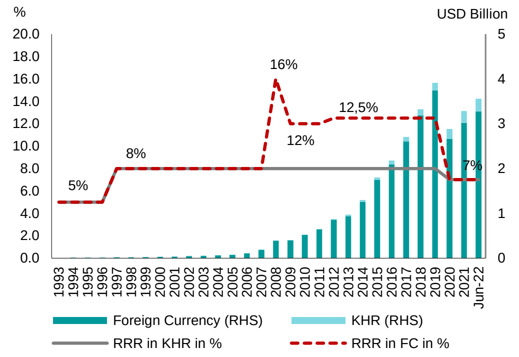
After the significant drawdown from reserves since the beginning of the pandemic, fiscal buffers have declined sharply but expected to rise again by 2024.



Source: MEF; AMRO staff calculations

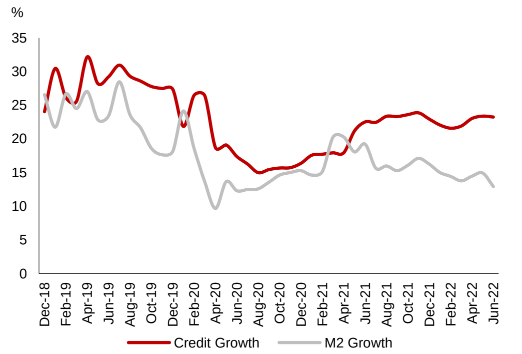
Figure 1.4. Monetary and Financial Sector

Reserve requirement rates continued to be accommodative at 7 percent for all currencies ...



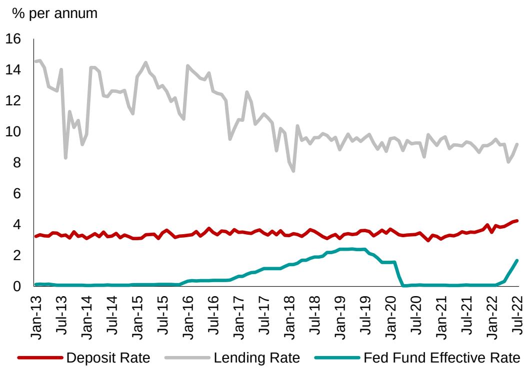
Source: NBC; AMRO staff calculations.

… providing banks with ample liquidity to finance the economy.



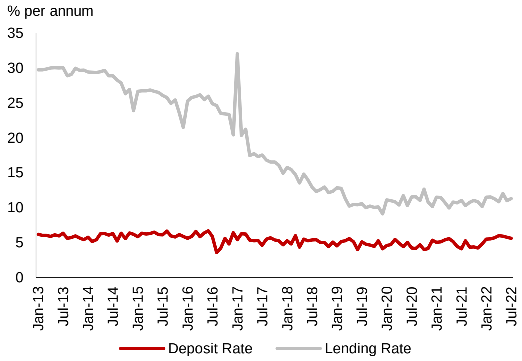
Source: NBC; AMRO staff calculations.

Bank's interest rates for USD deposit and lending were stable and did not follow the Fed's rate hike, similar to the past.



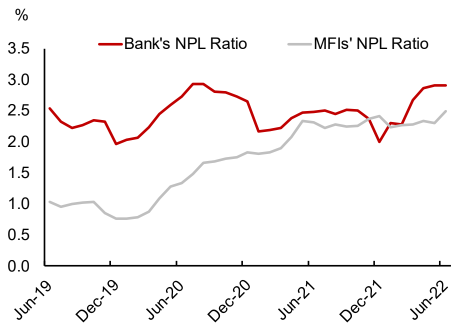
Source: NBC; FRED

KHR interest rates were similarly stable.



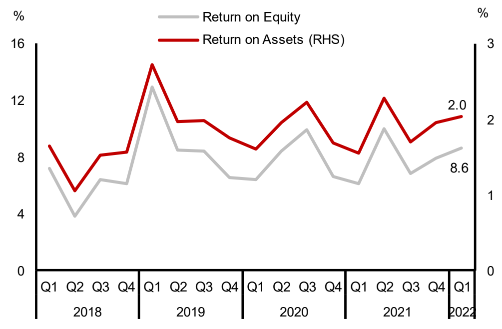
Source: NBC

NPL ratio has started to rise with the unwinding of regulatory forbearance but remain relatively low.



Source: NBC; AMRO staff calculations.

Profitability of banks as seen in terms of ROA and ROE has steadily risen since the reopening of the economy.



Source: NBC; AMRO staff calculations.

Appendix 2. Selected Economic Indicators for Cambodia

	2018	2019	2020	2021	Projections 2022	Projections 2023
Real Sector and Prices	**(In annual percentage change)**					
Real GDP	7.5	7.1	-3.1	3.0	5.0	5.4
Agriculture	1.1	-0.5	0.6	1.1	0.9	1.2
Industry	11.6	11.3	-1.4	8.6	6.1	5.3
Services	6.8	6.2	-6.3	-1.9	5.7	7.4
GDP deflator	3.1	3.2	-0.7	1.3	3.6	2.4
CPI inflation (average)	2.5	1.9	2.9	2.9	5.3	3.0
CPI inflation (end of period)	1.6	3.1	2.9	3.7	3.0	3.3
External Sector	**(In millions of USD, unless otherwise specified)**					
Current account balance	-2,894	-4,062	-2,197	-12,316	-10,285	-7,481
(Including gold, in percent of GDP)	-11.8	-15.0	-8.5	-45.7	-35.1	-23.6
(Excluding gold, in percent of GDP)	-9.9	-16.1	-16.8	-24.1	-21.9	-16.1
Trade balance	-5,844	-7,255	-2,544	-11,257	-11,142	-9,976
Exports	12,963	14,987	18,522	19,469	22,613	24,504
Imports	18,806	22,242	21,066	30,726	33,755	34,479
Services, net	2,395	2,812	-257	-1,447	486	2,039
Primary income, net	-1,331	-1,564	-1,050	-1,403	-1,530	-1,576
Secondary income, net	1,885	1,945	1,654	1,790	1,900	2,031
Financial account balance	3,977	6,725	3,276	12,360	9,468	8,672
Foreign Direct Investment	3,089	3,561	3,498	3,391	3,466	3,909
Other Investment	604	2,821	-385	8,777	5,749	4,515
Overall balance	1,445	2,668	637	83	-735	1,248
Gross international reserves	14,629	18,763	21,334	20,265	19,530	20,778
(In months of imports)	8.0	8.8	11.1	7.4	6.4	6.7
(In months of imports, excluding gold)	8.2	8.9	11.5	9.0	7.2	7.2
External debt	11,880	15,377	17,611	20,063	22,159	24,373
(In percent of GDP)	48.3	56.8	68.1	74.4	75.4	76.7
Fiscal Sector	**(In percent of GDP)**					
Revenue and grants	23.8	26.2	23.4	21.4	23.3	24.7
Tax revenue	19.0	22.0	20.1	18.3	19.9	21.3
Nontax revenue	3.1	3.3	2.4	2.2	2.5	2.6
Grants	1.8	1.0	1.0	0.9	0.8	0.8
Expenditure	23.8	26.9	28.8	29.9	28.7	29.5
Current non-interest expenditure	16.1	18.3	17.4	19.1	17.9	18.3
Interest payments	0.4	0.4	0.5	0.5	0.5	0.6
Capital expenditure	7.3	8.2	10.9	10.3	10.2	10.6
Overall fiscal balance	0.0	-0.6	-5.3	-8.5	-5.4	-4.8
Primary balance	0.4	-0.2	-4.9	-8.0	-4.9	-4.3
Public debt	28.4	28.1	33.8	35.0	35.9	36.8
Monetary and Financial Sector	**(In annual percentage change, end-period)**					
Domestic Credit	27.7	24.4	20.0	32.3	24.6	23.4
Credit to private sector	28.1	28.0	17.2	23.4	23.4	20.5
Broad money	26.6	18.2	15.3	16.3	14.3	12.8
Reserve money	16.8	34.5	-2.1	10.2	6.7	8.8
Memorandum Items						
Nominal GDP (KHR billion)	99,544	110,014	105,892	110,506	120,151	129,704
Nominal GDP (USD million)	24,572	27,089	25,873	26,961	29,334	31,669
GDP per capita (USD)	1,555	1,694	1,544	1,585	1,705	1,820
Exchange rate (KHR/USD, average)	4,051	4,061	4,093	4,099	4,096	4,096
Exchange rate (KHR/USD, end of period)	4,033	4,084	4,077	4,114	4,086	4,093

Source: National authorities; AMRO staff estimates

Appendix 3. Balance of Payments

	2015	2016	2017	2018	2019	2020	2021
	(In millions of USD, unless otherwise specified)						
Current account	**-1,598**	**-1,733**	**-1,799**	**-2,894**	**-4,062**	**-2,197**	**-12,316**
Trade balance	-3,949	-3,846	-4,278	-5,844	-7,255	-2,544	-11,257
Exports, f.o.b.	9,336	10,273	11,224	12,963	14,987	18,522	19,469
Imports, f.o.b.	13,285	14,119	15,502	18,806	22,242	21,066	30,726
Services, net	1,712	1,602	1,863	2,395	2,812	-257	-1,447
Receipts	3,955	4,033	4,608	5,451	6,086	1,767	657
Payments	2,242	2,430	2,745	3,056	3,274	2,025	2,104
Primary income, net	-998	-1,050	-1,140	-1,331	-1,564	-1,050	-1,403
Receipts	354	377	442	578	732	669	425
Payments	1,352	1,427	1,582	1,908	2,297	1,718	1,828
Secondary income, net	1,636	1,561	1,756	1,885	1,945	1,654	1,790
of which: official tranfer	526	506	550	579	532	449	549
Others	1,110	1,056	1,206	1,306	1,413	1,205	1,242
Capital and financial account	**2,382**	**2,901**	**3,671**	**3,977**	**6,725**	**3,276**	**12,360**
Capital account	265	283	279	326	355	260	244
Financial account (net)	2,117	2,618	3,393	3,651	6,370	3,016	12,116
Direct investment	1,735	2,397	2,673	3,089	3,561	3,498	3,391
Other investment	397	223	725	604	2,821	-385	8,777
Errors and omissions	47	296	-241	362	5	-442	39
Overall balance	831	873	1,631	1,445	2,668	637	83
Memorandum items:							
Exports of goods and services	13,291	14,306	15,832	18,414	21,073	20,290	20,126
Imports of goods and services	15,528	16,550	18,247	21,862	25,516	23,091	32,830
Trade account (percent of GDP)	-21.9	-19.2	-19.3	-23.7	-26.7	-9.8	-41.4
Current account (percent of GDP)	-8.9	-8.7	-8.1	-11.8	-15.0	-8.5	-45.3
Capital and financial account (percent of GDP)	13.2	14.5	16.5	16.2	24.8	12.6	45.5
Overall Balance (percent of GDP)	4.6	4.4	7.3	5.9	9.8	2.5	0.3
International reserves (USD million)	7,377	9,123	12,201	14,629	18,763	21,334	20,265
In months of imports of goods and services	5.7	6.6	8.0	8.0	8.8	11.1	7.4
GDP (USD million)	18,050	20,017	22,208	24,610	27,150	25,970	27,167

Source: National authorities; AMRO staff calculations.

Appendix 4. Statement of General Government Operations

	2017	2018	2019	2020	2021	2022BL
	(In percent of GDP)					
Total Revenue and Grants	21.9	23.8	26.2	23.4	21.4	22.2
Total Domestic Revenue	20.2	22.1	25.3	22.5	20.5	21.3
Central Govt	19.0	20.4	23.2	20.4	18.4	19.5
Local Govt	1.2	1.6	2.0	2.1	2.1	1.8
Current Revenue	20.1	21.9	25.1	22.3	20.5	20.2
Total Tax Revenue	17.3	19.0	22.0	20.1	18.3	18.2
Tax Revenue Central	16.2	17.4	20.0	18.3	16.7	16.8
Domestic Taxes	14.0	15.0	17.4	16.2	14.7	14.8
Direct Taxes	4.2	4.1	4.6	5.5	5.4	4.6
Indirect Taxes	9.7	10.9	12.8	10.7	9.4	10.3
VAT	5.5	5.8	7.4	6.2	5.4	5.9
Excise	4.2	5.2	5.4	4.5	4.0	4.4
Trade Taxes	2.2	2.4	2.6	2.1	1.9	2.0
Tax Revenue Local	1.1	1.6	1.9	1.8	1.6	1.3
Non-tax revenue Central	2.7	2.9	3.0	2.0	1.7	1.6
Non-tax revenue Local	0.1	0.0	0.1	0.2	0.5	0.5
Capital Revenue	0.2	0.2	0.2	0.2	0.1	1.1
Grants	1.7	1.8	1.0	1.0	0.9	0.9
Total Expenditure	22.8	23.8	26.9	28.8	29.9	28.0
Current Expenditures	15.6	16.5	18.7	17.9	19.5	17.7
Wages and Salaries	7.6	8.0	7.4	8.1	7.6	7.2
Non-wages	6.4	6.7	8.9	7.9	9.4	8.4
Interest Payment	0.4	0.4	0.4	0.5	0.5	0.5
Domestic	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	0.4	0.3	0.4	0.5	0.5	0.5
Capital Expenditures	7.2	7.3	8.2	10.9	10.3	10.3
Domestic Financed	2.5	3.0	3.6	6.0	5.6	5.5
Foreign Financed	4.7	4.3	4.6	4.9	4.7	4.8
Current Balance (excl. grant)	4.4	5.4	6.4	4.4	0.9	2.5
Primary Balance (excl. grant)	-2.2	-1.3	-1.2	-5.9	-8.9	-6.2
Fiscal Balance (incl. grant)	-0.9	0.0	-0.6	-5.3	-8.4	-5.9
Fiscal Balance (excl. grant)	-2.6	-1.7	-1.6	-6.3	-9.3	-6.7

Sources: National authorities; AMRO staff calculations
Note: 2022 GDP share is based on AMRO's projection. BL = Budget Law

Appendix 5. Data Adequacy for Surveillance Purposes: a Preliminary Assessment

Criteria/ Key Indicators for Surveillance	Availability[(i)]	Reporting Frequency/ Timeliness[(ii)]	Data Quality[(iii)]	Consistency[(iv)]	Others, if any[(v)]
National Accounts and Labor Market	- GDP numbers on the production and expenditure side have been made available - Unemployment and labor market data are available on the website	- The dissemination of GDP data is on an annual basis with a time lag of three to seven months - Data on the labor market has a lag of more than one year	National Accounts statistics are compiled broadly in accordance with SNA93 standards. Data collection techniques remain weak due to resource constraints. The authorities plan to release the GDP data based on SNA 2008.	Revisions are frequent but becoming less significant. Officially, the statistical discrepancy is also shrinking	- The data quality of the National Accounts data could be improved using a more comprehensive Supply Used Table (SUT) based on the latest survey - The GDP data on the expenditure side remains relatively weak with underestimated gross fixed capital formation
Balance of Payments (BOP) and External Position	- BOP data is published on the NBC website - Import and export data is published by the MEF - Import data breakdown by category, destination and origin is not yet available	- BOP data is released on a quarterly and yearly basis with a time lag of one to three quarters - Trade data is released on a monthly basis with a time lag of one month.	- Since 2019, the BOP has been published in conformity with the BPM6 but some coverage limitations exist - Import data published by the MEF is incomplete, as it covers only major items	-	-
State Budget and Government/ External Debt	- Budget implementation data is released on the MEF website - Budget implementation data does not include local government budget operation - Contingent government liability statistics are not yet available	Budget implementation statistics are published on a monthly basis with a time lag of one to three months	The data coverage is limited to the budget and is not fully integrated with activities related to the disbursement of external loans and grants	The breakdown of budget implementation data from TOFE is different from the one provided by the GD of Budget.	-
Money Supply and Credit Growth	- CPI data for Phnom Penh is published by the NIS - National CPI data is yet to be made available - Monetary statistics have been released on the NBC website - Data on credit breakdown by sector is also available	- CPI data is released on a monthly basis with a time lag of one to three months - Monetary and credit data is published on a monthly basis with a time lag of three months.	- The compilation of the CPI suffers from insufficient coverage - The authorities plan to release CPI data with much wider coverage - The actual amount of dollars and other foreign currency-denominated bills circulating in the economy has not been captured in the official monetary statistics	-	Regular and timely (schedule-based) publication of headline and core inflation would strengthen economic monitoring
Financial Sector Soundness Indicators	- Foreign assets and liabilities for the banking sector in aggregate are published by the NBC - A detailed breakdown of the composition of foreign assets and liabilities of the banking sector is not yet available	Yearly data is released on the NBC website with a time lag of three to six months	- Indicators are generally based on reports from banks and MFIs - In addition to banking indicators, data on microfinance activities is lacking	-	The availability of more comprehensive and more frequent data, including a detailed breakdown of assets and liabilities, would help in the analysis of financial-sector soundness as a whole

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

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

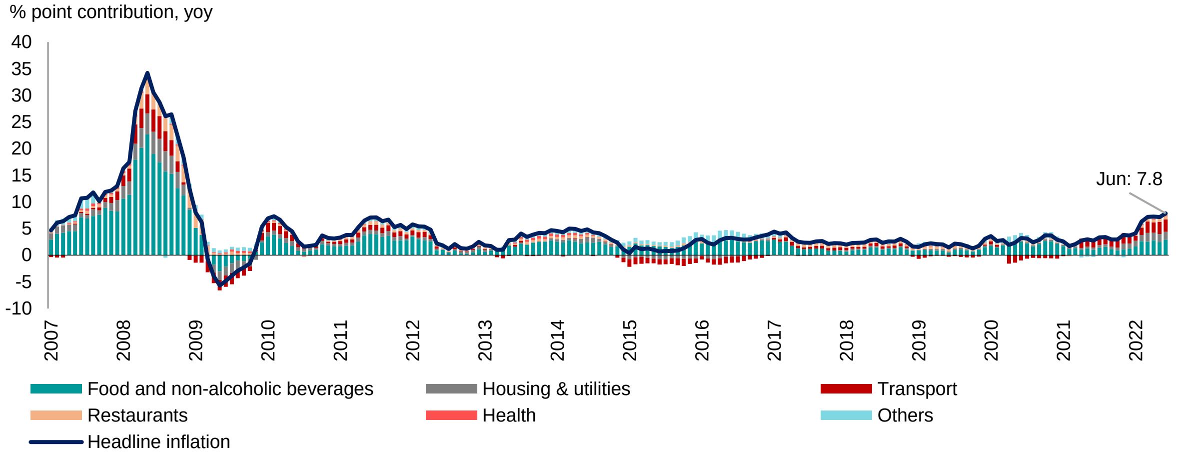
Annexes: Selected Issues

Annex 1. Drivers of Inflation Dynamics: The Case of Cambodia[33]

Background

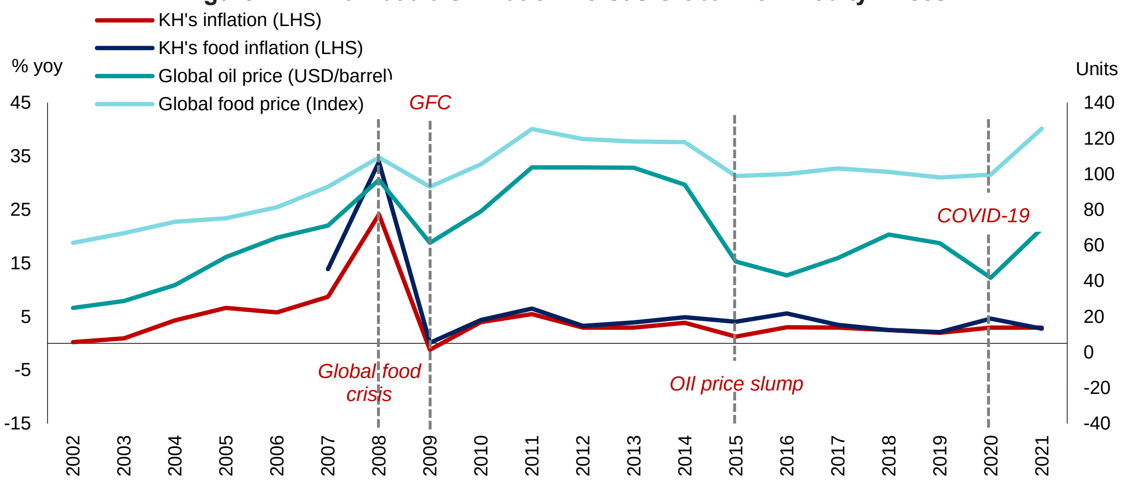
1. **Cambodia has exhibited a record of low inflation over the past decades, yet volatility remains.** With the exception of 2008, the country's inflation averaged 2.9 percent during 2000–21, largely driven by food and transport inflation (Figures A1.1, A1.2). However, high volatility of inflation in Cambodia has been observed in tandem with several key episodes of commodity price shocks, for instance during the 2008 global food crisis, the 2015 world oil price slump, as well as the recent Russia-Ukraine conflict leading to the spike in energy prices Figure A1.2). Against this backdrop, this selected issue looks at the developments of Cambodia's inflation in different periods, while aiming to determine key mechanism of inflation transmission and decomposing demand and supply factors in the inflation dynamics. The last part of the selected issue focuses on policy implications—tailored to the country's economic conditions as a highly-dollarized economy.

Figure A1.1. Cambodia: Monthly Inflation by Component



Source: NIS; AMRO staff calculations
Note: The CPI data covers only Phnom Penh, but is used as a proxy for nationwide CPI.

Figure A1.2. Cambodia's Inflation Versus Global Commodity Prices

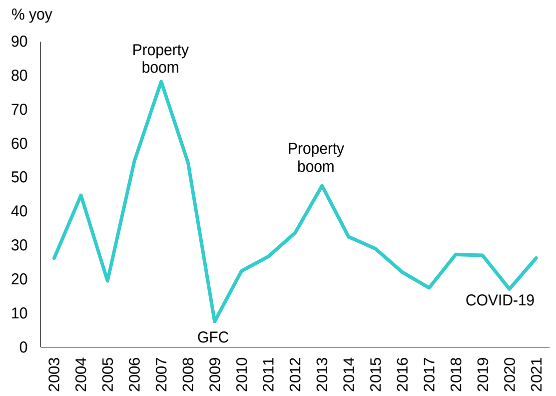


Source: NIS; IMF; World Bank; AMRO staff calculations
Note: KH = Cambodia; GFC = global financial crisis; LHS = left hand side

[33] This selected issue was prepared by Vanne Khut, Economist.

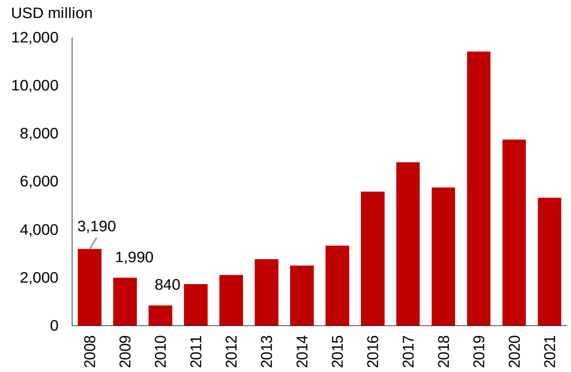
2. **Cambodia's inflation accelerated in 2008 on an exceptional surge in prices led by both domestic and external shocks.** The 2008 global food crisis contributed to a sharp rise in Cambodia's food CPI by 34.0 percent, bringing the headline inflation to 24.1 percent in 2008, from an average 3.2 percent in the preceding period of 2000–2007 (Figure A1.1). A number of interacting factors were at play in driving the global food crisis, including high oil prices, higher demand for biofuels, export restrictions, frequent natural disasters, among others (European Commission, 2011) (Ross, 2017). Domestically, a drastic increase in property prices and high credit growth were also contributors. Credit to the private sector grew rapidly at 66.3 percent during 2007–08 (Figure A1.3), amid the surge in property prices in Phnom Penh by a whopping 80-100 percent in 2008, after rising 50–80 percent a year earlier. In central locations, land prices soared to more than USD3,000 per square meter, up from roughly USD500 in 2003, along with rental prices jumping 20–40 percent (Kolesnikov-Jessop, 2008). However, in the run-up to the 2009 global financial crisis, construction investment started to decline steeply by 37.6 percent (yoy) to USD1.99 billion in 2009 and eventually to just USD840 million in 2010 (Figure A1.4).

Figure A1.3. Cambodia: Credit Growth



Source: NBC; AMRO staff calculations
Note: Credit growth was calculated based on the data from monetary survey (financial corporation survey), given the need for long historical data. GFC = global financial crisis

Figure A1.4. Cambodia: Construction Investment

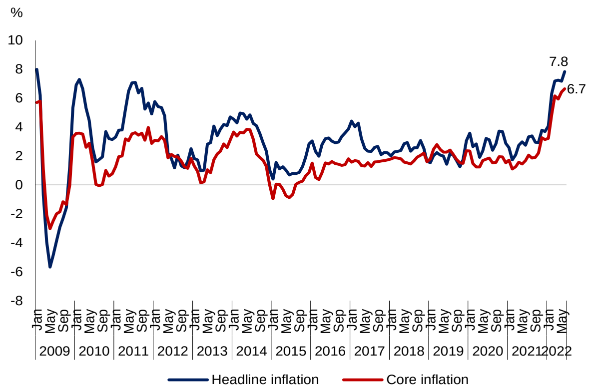


Source: Ministry of Land Management, Urban Planning and Construction
Note: Data refers to *approved* value of construction investment projects.

Cambodia's Inflation Dynamics during the COVID-19

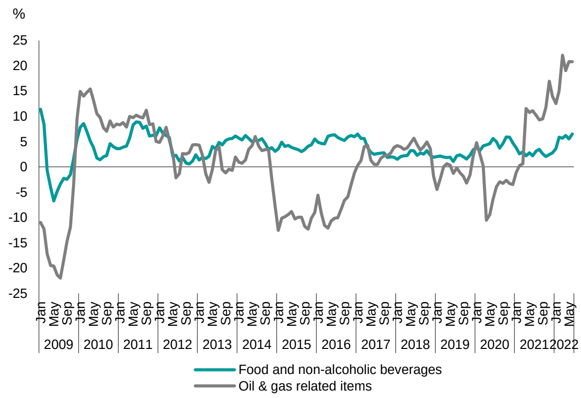
3. **The volatility of inflation during 2020–22 largely reflects pandemic shocks and more recently an upsurge in global commodity prices**. In 2020 when the pandemic struck, the inflation reached 2.9 percent from 1.9 percent in the previous year, mainly due to pandemic-induced supply disruptions—notwithstanding the tumble in oil prices, and then remained stable in 2021 before soaring to new heights at 7.8 percent in June 2022 (Figures A1.1, A1.2). Characterized as a net oil importer, Cambodia is experiencing upward inflationary pressures on the back of the skyrocketing energy prices since the start of the Russia–Ukraine war. The energy price shocks have already fed into prices of other products, evidenced by the continued increase in core inflation to around 6.7 percent (yoy) in June 2022 (Figures A1.5, A1.6). Moreover, as the economy fully re-opens and the recovery gathers steam, domestic demand is improving, contributing in part to the rising inflation. That said, concerns among businesses and households have been mounting since business costs keep rising and are eventually passed on to consumers—reducing their purchasing power.

Figure A1.5. Cambodia: Headline and Core Inflation



Source: NIS; AMRO staff calculations
Note: Core inflation excludes items, such as food and non-alcoholic beverages, and oil and gas related items (fuels and lubricants for personal transport equipment; electricity, gas and other fuels; and transport services).

Figure A1.6. Cambodia: Food and Energy Inflation



Source: NIS; AMRO staff calculations
Note: Oil and gas related items include fuels and lubricants for personal transport equipment; electricity, gas and other fuels; and transport services.

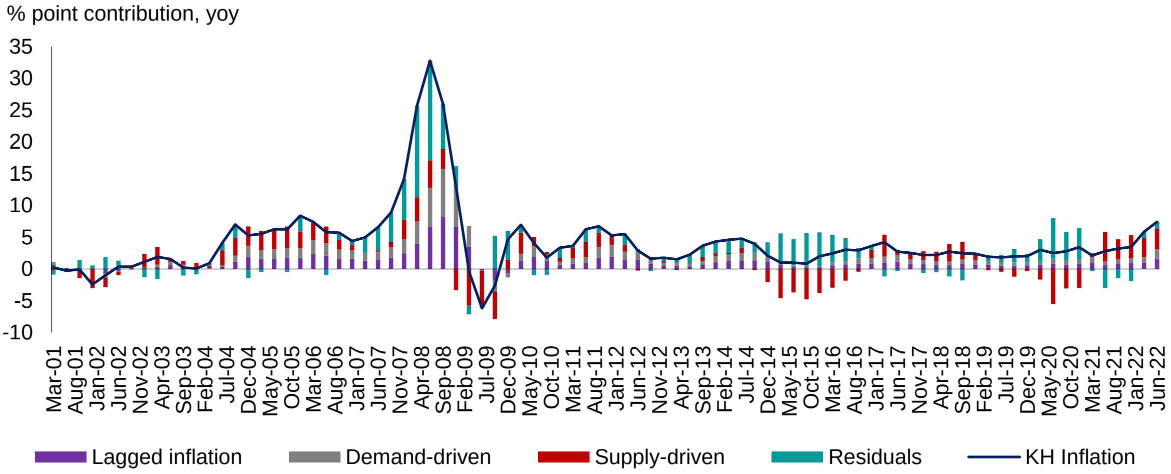
4. **Supply-side pressures have a major role to play in Cambodia's inflation dynamics.** According to the so-called Triangle model of inflation (Gordon, 1990) (See Box A1), Cambodia's inflation is partly cost-push, especially from global energy and food prices (Figure A1.7). This could be explained by the fact that Cambodia has very weak and narrowly based industrial sector—primarily dominated by garment manufacturing,[34] and has therefore been heavily reliant on imports for both domestic final consumption and investment. Latest data indicate that all fuel used for both consumption and investment is imported, while the bulk of machinery; electrical, optical and transport equipment; clothing; chemicals and other manufacturing products are largely imported (Figure A1.8). especially in the ASEAN+3 region, making up about 84.0 percent of total imports in 2021.[35] As a result, the surge in global prices can lead to higher prices of Cambodia's imports—or referred to as "imported inflation," which translates to higher prices passing through to domestic consumers. It is worth noting that large residuals—reflecting idiosyncratic factors in driving inflation—notable in certain periods as depicted in Figure A1.7 could be associated with domestic factors, e.g., the spike in property prices and accelerated credit growth in 2007-08, the El Niño-induced drought in 2015, unprecedented flooding in 2020, and perhaps the large fiscal stimulus package over the course of the pandemic.[36]

5. **Demand-pull factors are more evident mostly in times of crisis that induce negative demand shocks.** The early phase of the COVID-19 pandemic created domestic and external demand shocks, causing Cambodia's domestic consumption expenditure to slip into contraction of 3.0 percent in 2020—the fastest fall in over 2 decades (Figure A1.9). This could be traced back to when the government tightened containment measures, e.g., lockdowns, travel restrictions, to flatten the curve of the COVID-19 infections, while the global mobility was also restricted, impacting Cambodia's external-demand dependent sectors. Tourism and

[34] Source: **Cambodia Industrial Development Policy 2015–2025**
[35] Note: The authority's data has limited breakdown on imports by country, and hence the imports from ASEAN+3 economies exclude Korea and Hong Kong, China. Source: Ministry of Economy and Finance (Cambodia); AMRO staff calculations
[36] The government rolled out a large fiscal stimulus for 2020-21, amounting to 6.6 percent of GDP (AMRO, 2021)

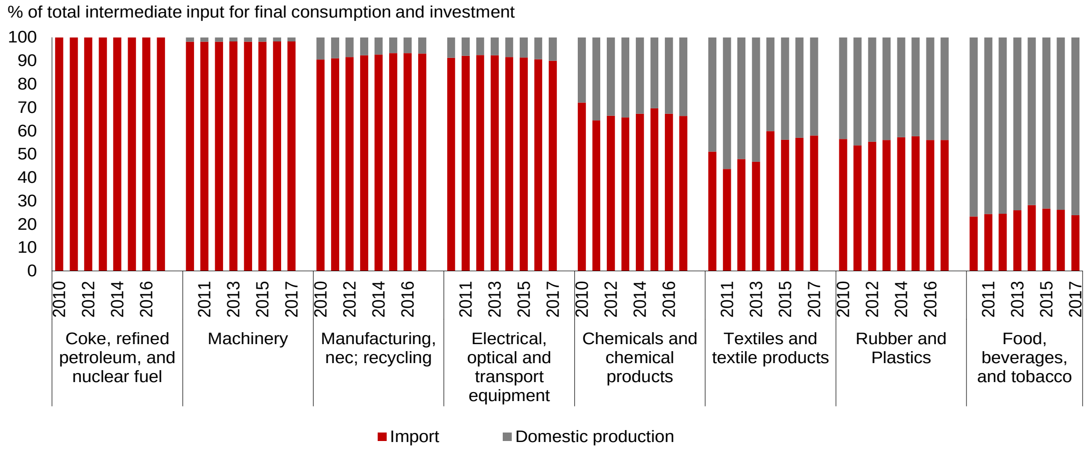
garment industries, for example, were hard hit, and therefore people's income and livelihoods were greatly affected.[37]

Figure A1.7. Cambodia: Inflation Dynamics



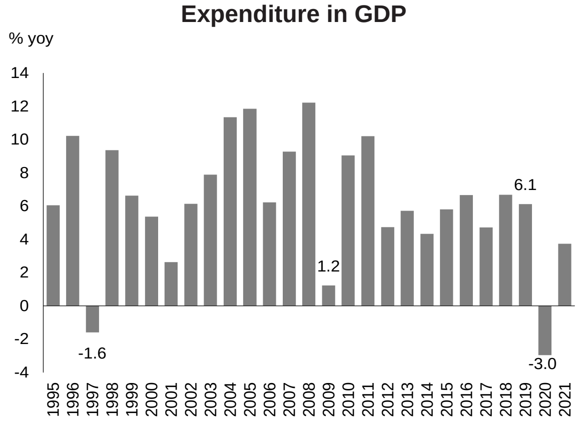
Source: NIS; The IMF; The World Bank; AMRO staff estimates
Note: Supply-driven includes global oil and food prices, while the demand-side is proxied by the country's output gap.

Figure A1.8. Cambodia: Intermediate Input for Final Consumption and Investment by Selected Sectors



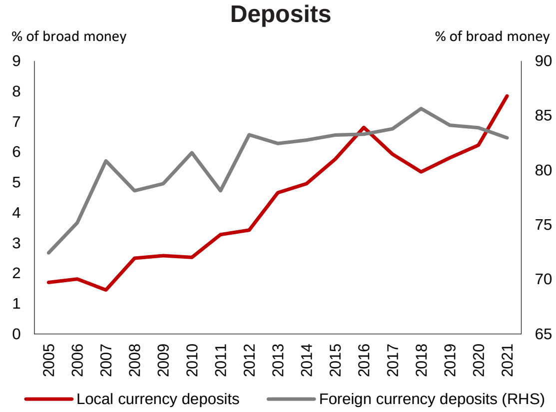
Source: Asian Development Bank; AMRO staff calculations
Note: The calculations are based on ADB's Input Output Tables.

Figure A1.9. Cambodia: Real Final Consumption Expenditure in GDP



Source: NIS; AMRO staff calculations

Figure A1.10. Local and Foreign Currency Deposits



Source: NBC; AMRO staff calculations

[37] Alongside the lay-offs and factory closures in the garment sector, the collapse in tourism industry led to a marked decline in travel and tourism employment by 27.9 percent in 2020, while domestic tourism spending also dipped considerably by 36.1 percent over the same period (AMRO, 2022). As a result, Cambodia saw higher unemployment rate of 2.4 percent in 2020 from 0.1 percent in 2019 (Source: World Bank).

Policy Implications

6. **The NBC should continue to maintain exchange rate stability as an anchor against inflationary shocks in the highly dollarized economy.** As a highly dollarized economy with no capital controls, Cambodia has limited monetary policy instruments to control domestic inflation, a major part of which is imported. Moreover, exchange rate stability in economies with high level of dollarization could be threatened, especially when central banks do not have adequate foreign reserves to defend the exchange rate(Campos, 2022). In this regard, the NBC should continue to build up its foreign exchange in order to maintain exchange rate stability to help mitigate inflationary pressures.

7. **Gradual de-dollarization efforts should be continued to wean the economy off its dollar dependence and strengthen the monetary autonomy.** From a longer-term perspective, the NBC's steadfast endeavors to promote the use of local currency should continue.[38] While the foreign currency deposits remain high at above 80 percent of broad money, continuous improvement has been seen in local currency deposits, with their share rising to 7.9 percent of broad money in 2021 from just 1.7 percent in 2005 (Figure A1.10). Meanwhile, lending in local currency has also witnessed a significant improvement, with its share rising from just 1.5 percent of total loan portfolios in 2016 to 11.4 percent in 2021,[39] reflecting the effectiveness of the NBC's regulation that requires banks and MFIs to allocate at least 10 percent of their loan portfolios in local currency.

8. **Expanding domestic production for domestic supply could be a longer-term policy option to help cushion the pass-through effects of swings in import prices.** Our empirical results highlighted that Cambodia's inflation is attributable in part to imported inflation. Endowed with some natural resources, such as timber and forest products, and a rapidly growing and young labor force,[40] Cambodia should seize the opportunity to create more value added to the economy by processing the natural resources, rather than exporting unprocessed products, particularly in the agricultural sector.[41] However, this requires skill upgrading and technology transfer to allow local enterprises to acquire the expertise and technical know-how needed to enter the manufacturing processing industry. The establishment of the SME bank and the Skill Development Fund in the past few years is a great stepping stone to promote growth in domestic production and supply, and raise productivity of the labor force.

Box A1. Triangle Model of Inflation: Data, Methodology and Empirical Result

This empirical study employs the Triangle Model of Inflation (Gordon, 1990), which explains the rate of inflation with its inertia or trend, demand and supply factors. The monthly data covers the period from January 2000 to June 2022. Independent variables are comprised of lagged inflation, Cambodia's output gap, global oil prices, and global food prices. Other variables that were also considered include the exchange rate, and US output gap as a measure of external demand for Cambodia's export goods. However, these variables were found to be statistically insignificant and were hence removed from the model. A possible explanation on the insignificance of the exchange rate could be due to Cambodia's exchange rate regime being managed floating, which helps lessen the fluctuations of Khmer Riel in the domestic market and therefore has a very limited role in explaining the inflation.

[38] These include lower reserve requirement for KHR relative to foreign currencies, setting a minimum threshold of lending in KHR of at least 10 percent of bank loan portfolios, calling back small US dollar notes to raise KHR circulation in the economy, among others.
[39] Source: NBC
[40] The median age in Cambodia is 25.6 years (Source: **Worldometer**). Cambodia has the highest labor force participation rate in the Southeast Asia/Pacific region (82.7 percent of the working population aged 16-64) (International Labour Organization, 2018).
[41] Over 90 percent of Cambodia's agricultural exports were unprocessed (Open Development Cambodia, 2016).

1. Data and Source

All the data from January 2000 to June 2022 are sourced from national authorities, the IMF, and the World Bank.

2. Methodology

Indicated below is the basic structure of the econometric model adopted in the study.

$$\Delta log(CPI)_t = \beta_0 + \beta_1 \Delta log(CPI)_{t-1} + \beta_2 (Output\ gap)_{t-1} + \beta_3 \Delta log(Food\ Price)_{t-1} + \beta_4 \Delta log(Oil\ Price)_t + Dummy + \varepsilon_t$$

where:

<u>Dependent variable</u>

$\Delta log(CPI)_t$: Log difference of monthly CPI index

<u>Explanatory variable</u>

$\Delta log(CPI)_{t-1}$: Lagged log difference of CPI index, as proxy of inflation inertia or trend

$(Output\ gap)_{t-1}$: Cambodia's output gap represents demand-driven factor. Cambodia's quarterly real GDP data are interpolated from annual data series.

$\Delta log(Food\ Price)_{t-1}$: Log difference of global food price index representing supply-driven factor

$\Delta log(Oil\ Price)_t$: Log difference of global oil price representing supply-driven factor

$Dummy_t$: Dummy variable applied to certain crisis periods: 2008, 2009 and 2020

ε_t : Error term

All variables are seasonally adjusted to smooth periodic swings in the data. A 1-month lag was also imposed on most independent variables such as trend inflation, output gap, and global food prices. However, the global oil price indicator was used with no lag, taking into account the government's policy to ensure that domestic retail oil prices reflect the same month's global oil prices.[42] A fixed tax rate[43] on gasoline import has also been implemented to restrain excessive fuel prices (Vanyuth, 2022). In addition, the standard error was estimated using HAC (Newey-West) covariance method.

3. Empirical Result

The result suggests that all the independent variables are statistically significant and play an important role in driving Cambodia's inflation, be it demand or supply-driven. The supply-driven indicators—global oil and food prices—are statistically significant at the 1-percent and 5-percent level, respectively. Representing a demand-driven factor, the output gap is also statistically significant at the 5-percent level (Table B1). The lagged inflation is also significant at the 5-percent level.

Table BA1.1. Empirical Result

Variable	Coefficient	Std. Error	t-Statistic	Prob.
$\text{Lagged inflation}_{t-1}$	0.290**	0.123	2.357	0.021
Output gap_{t-1}	0.267**	0.104	2.562	0.012
$\Delta\text{log(Oil Price)}_t$	0.042***	0.014	2.921	0.005
$\Delta\text{log(Food Price)}_{t-1}$	0.069**	0.032	2.178	0.032
Dummy	0.019	0.008	2.502	0.014
Constant	0.002	0.002	1.364	0.176
$R-\text{squared}$	0.536			
$\text{Adjusted } R-\text{squared}$	0.507			

Note: ***, ** and * denote significance at 1 percent, 5 percent and 10 percent level, respectively.

[42] The formula for domestic retail oil prices is Retail oil price/liter = Mean of Platts Singapore + taxes (customs duty + VAT + special tax) + Premium + VAT Out. (Source: Ministry of Commerce, dated June 22, 2018).
[43] A 15-percent customs duty has been levied on gasoline import since 2017 (Source: Ministry of Economy and Finance).

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Annex 2. The Phasing Out of the Loan Restructuring Program and the Implications on the Banking Sector[44]

1. The loan restructuring program was introduced in March 2020 when the economy started to be adversely impacted by the COVID-19 outbreak. Despite very few COVID-19 cases and light social-distancing measures at the early stages of the pandemic, the fall in demand in major export markets and restrictions on international travel by many countries hit Cambodia's key growth drivers hard. Against this backdrop, the NBC swiftly introduced the loan restructuring program in the same month that WHO declared COVID-19 a global pandemic, to ease the burden of borrowers who had lost their primary incomes and facing difficulties in repayment. This program was initially planned to run until the end of 2020, and only loans in four priority sectors – garment, tourism, transportation, and construction – could be restructured without downgrading the classification or setting aside more provisions (Table A2.1).

Table A2.1. Policy Development Relating to the Loan Restructuring Program

Policy announcement time	Forbearance period	Restructuring times allowed	Eligible sectors	Loan classification	Provisions requirement	Policy stance change
Mar 2020	Until end-2020	One time	Four sectors: garment, tourism, transportation and construction	Keep current classification	No additional provisions are required	Eased (the regulatory requirement was relaxed)
Nov 2020	Extended to mid-2021	Up to three times	All sectors	Keep current classification	No additional provisions are required	Eased (extended, more restructurings were allowed, and more sectors were eligible)
May 2021	Extended to end-2021	For borrowers who are in quarantine areas: their loans can be restructured as many times as possible For other borrowers: up to three times	All sectors	Keep current classification	No additional provisions are required	Eased (extended, and more restructurings were allowed)
Jun 2021	Until end-2021	For borrowers who are in quarantine areas: their loans can be restructured as many times as possible For other borrowers: up to three times	All sectors	Keep current classification	Gradually record provisions when restructured loans are impaired	Preparing orderly exit (more provisions were required)
Dec 2021	Extended to June-2022	Starting from Jan 2022, only loans that have not been restructured before can apply for restructuring	All sectors	All loans restructred by end-2021 shall be classified accordingly except for loans in the assessment period	Institutions are required to make provisions for all loans restructured by end-2021 accordingly except for loans in the assessment period	Preparing orderly exit (though extended, the eligible critiria was stricter, and reclassification and more provisions were required)

Source: NBC; news sources collected by AMRO
Note: Banks were allowed to restructure loans in nine different ways, including 1) reducing the amount of loan principal, 2) lowering the interest rate, 3) deferring the repayment, 4) extending the maturity date, 5) adding and/or modifying co-borrower and/or guarantor, 6) changing an installment loan to bullet loan, 7) releasing collaterals, 8) easing of covenants, and 9) providing grace period.

2. After the first announcement, the NBC extended the program and relaxed the requirement several times to adapt to the constantly-changing COVID-19 pandemic and economic condition (Table A2.1). As the negative impact of COVID-19 spread to the whole economy, the first two policy amendments were made in November 2020 and May 2021, respectively, in order to allow more borrowers benefit from this program by extending the forbearance period from end-2020 to end-2021 as well as allowing for loans to be restructured multiple times.[45] Besides, the loan restructuring program was expanded from four priority sectors only to all sectors since November 2020.

[44] This selected issue is prepared by Yang Chunyu, Associate Economist.
[45] In times of normal practice prior to the onset of COVID-19, a loan that was restructured more than once would be classified as "substandard" or worse.

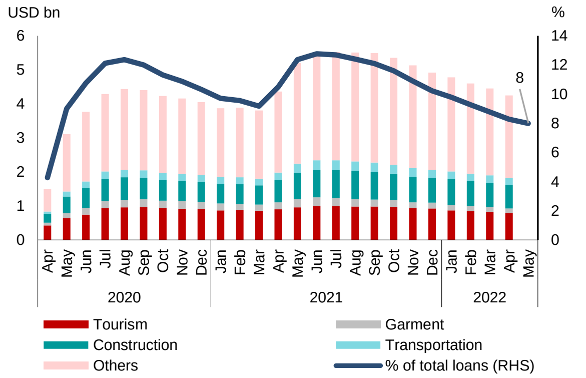
3. Since the middle of 2021, when the economy started gaining momentum, more prudential arrangements were made for the orderly exit from the restructuring program (Table A2.1). In June 2021, the NBC required banks and microfinance institutions (MFIs) to gradually provide provisions when restructured loans are impaired instead of waiting until the end of the forbearance period, to cushion against a sharp increase in NPLs. In December 2021, the NBC further asked these institutions to reclassify all loans restructured by the end of 2021 to different categories based on the assessment of repayment capacity and to make provisions accordingly (Table A2.2), except for loans still in the assessment period.[46] Notably, starting from January 2022, only borrowers that have not applied previously can apply for the restructuring, with the forbearance period opened until the end of June 2022.

Table A2.2. Classification Standard and Provision Requirement

Type of Restructured Loans			Requirement: Classification	Requirement: Provisions
Viable		---->	Performing (Special Mention)	3%
More restructuring needed	in its 1st restructuring	---->	Non-performing (Substandard)	20%
	in its 2nd restructuring	---->	Non-performing (Doubtful)	50%
Non-viable		---->	Non-performing (Loss)	100%

Source: NBC

Figure A2.1. Outstanding Restructured Loans



Source: NBC
Note: This chart refers to all restructured loans in the banking system. During April to October 2020, only loans in four sectors (tourism, garment, construction and transportation) enjoyed the relaxed regulation requirement. Since November 2020, all loans can enjoyed it.

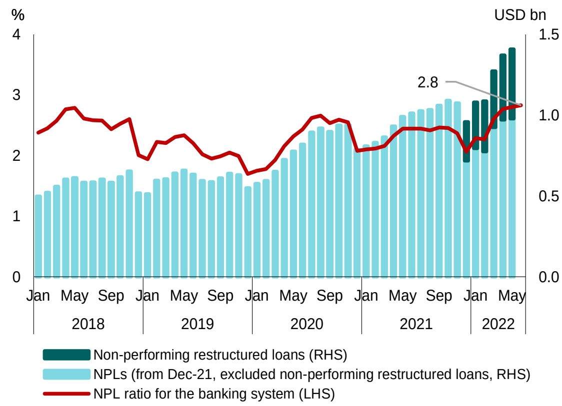
4. Throughout the implementation period, the loan restructuring program assisted borrowers in recovering from the pandemic. Restructured loans reached the first peak at 12.4 percent of total loans in August 2020 as the global economy was hit hard, and reached the second peak at 12.8 percent in June 2021 amid the surge of the Delta variant and tightening mobility restrictions domestically. Since then, the outstanding restructured loans have steadily declined on the back of the economic recovery and prudential requirements made by the NBC. In May 2022, restructured loans accounted for only 8 percent of total loans, among which the new restructured loans in H1 2022 were quite limited. Among outstanding restructured loans, the four priority sectors, which have enjoyed the program from the beginning, accounted for 43 percent in April 2022, with tourism loans, construction loans, transportation loans and garment loans comprising 19, 16, 5 and 3 percent respectively (Figure A2.1).[47]

5. Meanwhile, the loan restructuring program has prevented a significant deterioration of credit quality, although NPL ratio will eventually pick up in 2022. The loan restructuring program, which allows banks and MFIs to maintain the the same loan classification prior to the restructuring, has helped to preserve a relatively flat NPL ratio, although it does not fully reflect the level of debt distress. That said, the NPL ratio rose in the first three quarters of 2020

[46] For loans with monthly installments and maturity of less than one year, the assessment period starts from the first repayment after restructuring to the third repayment, or two months, in other words. For other loans, the assessment period is six months starting from the first repayment after restructuring. During the assessment period, no reclassification or additional provisions are needed.
[47] In May 2022, other sectors accounted for 57 percent of total outstanding loans. In detail, retail trade loans comprised 16 percent, followed by agriculture loans and personal lending loans which both comprised 7 percent respectively.

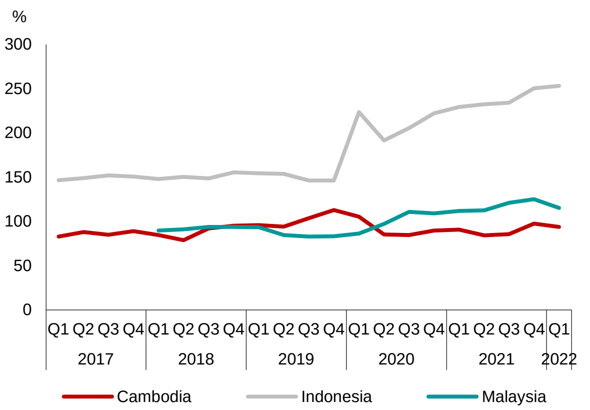
as a certain amount of loans that were not restructured have turned into NPLs,[48] reflecting negative shocks from the overall economic slowdown. Starting from 2022, restructured loans that need more restructuring or are already non-viable, are being classified as NPLs, pushing up the NPL ratio to 2.8 percent in June 2022, the highest since mid-2018. As 43 percent of restructured loans were still in the assessment period as of the end of May 2022, the NPL ratio may rise further when banks complete their assessment of all loans (Figure A2.2).

Figure A2.2 Non-performing Loans



Source: NBC; AMRO staff calculations

Figure A2.3. Country Comparison of the Provision Coverage Ratio



Source: NBC; Bank Negara Malaysia; Moody's; AMRO staff calculations
Note: The data for Indonesia only includes major banks.

6. However, the restructuring program with looser provisioning requirements, which has helped banks' profitability and liquidity conditions in the short term, imply that provisioning may be inadequate during the forbearance period. Before the pandemic, the provision coverage ratio, or the provision to NPL ratio, steadily increased to 113 percent at the end of 2019 from 83 percent in Q1 2017.[49] However, since no additional provisions were required for restructured loans, the provision coverage ratio has declined to the 80-90 percent range since Q2 2020. Hence, the amount of provisions might not be sufficient to cover future losses, considering the masked NPL ratio. This is different from some countries that had also introduced similar programs. For example, in Indonesia and Malaysia, although there were no requirements for additional provisions from the authorities, banks had voluntarily increased their provisions in preparation for an increase in the NPL ratio, leading to an even higher provision coverage ratio than before the pandemic (Figure A2.3).

7. Banks has restarted provisioning for restructured loans since December 2021 as required by the NBC, but the progress remains slow during the ongoing assessment period. As shown in Table A2.2, banks are required to increase provisions since the beginning of 2022. Indeed, the overall provisions increased to USD1,188 million in Q1 2022 from USD938 million in Q4 2021. However, as 43 percent of restructured loans were still in the assessment period as of the end of May 2022, and no additional provisions are required for those loans, the current provisions for the restructured loans account for only 8.3 percent of total restructured loans (Table A2.3).

[48] According to the NBC's circular, banks shall have policies and procedures to determine the situations and conditions that loans be regarded as "restructured loans", meaning that not all loans which applied for the restructuring can be approved.
[49] According to the "Prakas on Credit Risk Grading and Impairment Provisioning", announced by NBC in end-2017, there are two ways of calculating provisions. One is based on the expected credit losses (ECL) and the other one is using fixed ratios for different loan categories (i.e., 1 percent for normal loans, 3 percent for special mention loans, 20 percent for substandard loans, 50 percent for doubtful loans and 100 percent for loss loans). The method that requires higher provision will be implemented, and in practice most banks adopt the latter one.

Table A2.3. The Classification Result of Restructured Loans (as of end May 2022)

Loan classification	Restructured loans outstanding (USD mn)	Restructured loans outstanding (% share)	Current provisions (USD mn)	Provisions / restructured loans (%)
Special mention	1,761.4	45.7	53.2	3.0
Substandard	189.9	4.9	39.2	20.6
Doubtful	71.0	1.8	34.6	48.8
Loss	179.5	4.7	178.4	99.4
Others, still under assessment	1,655.9	42.9	16.1	1.0
Overall conditions	**3,857.6**	**100.0**	**321.4**	**8.3**

Source: NBC

8. Despite banks' capital adequacy ratio (CAR) being well above the minimum requirement, close monitoring of loan quality and timely increases inprovisioning for restructured loans would enhance the solvency of the banking sector. Nevertheless, our simulation exercise indicates that the CAR of the banking system will still be well above the regulatory requirement. We consider three scenarios for the loan quality of restructured loans in the assessment period (Table A2.4). In each scenario, the reclassification will affect the overall NPL ratio and additional provisions needed. A shortfall of provisions would be deducted from Common Equity Tier 1 (CET1) capital. Based on current requirement on provisions, if all loans in the assessment period turn out to be a "loss", the CET1 ratio and CAR will still be above 17 and 20 percent, respectively. This positive result is supported by improved profitability since Q3 2021 (see Appendix 1, Figure 1.4) as well as the solid CAR over time (see the main body Section A.3, Figure 15). Having said that, this simulation exercise only considers the legacy issue of restructured loans instead of any potential risks in the future, and the computed results of provisions are dependent on the authorities' guidance instead of the expected credit loss. Therefore, close monitoring and the timely evaluation of loan quality should be continued to maintain resilience of the banking sector.

Table A2.4. Simulation Exercise on Capital Adequacy Ratio

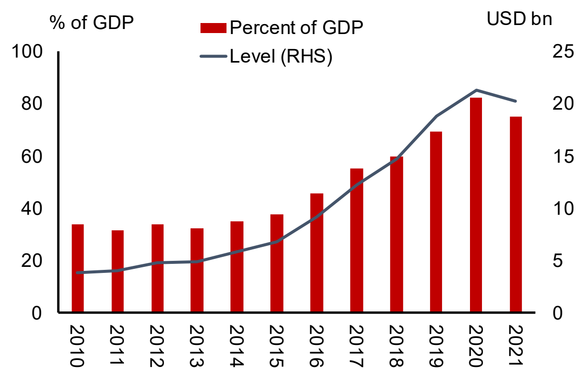
Scenario	Details	NPL ratio (%)	Total provision for restructured loans (KHR bn)	Additional provision needed (KHR bn)	Common Equity Tier 1 (CET1) ratio (%)	Capital adequacy ratio (%)
Scenario 1	For loans in assessment period: - 50% viable - 30% substandard - 15% doubtful - 5% loss	4.9	2,997	1,680	20.4	23.3
Scenario 2	For loans in assessment period: - 0% viable - 50% substandard - 30% doubtful - 20% loss	6.8	4,885	3,569	19.6	22.5
Scenario 3	All loans in assessment period turn out to be "loss"	6.8	9,089	7,772	17.7	20.6

Source: NBC

Annex 3. Long-term Costs of Financing Current Account Deficits[50]

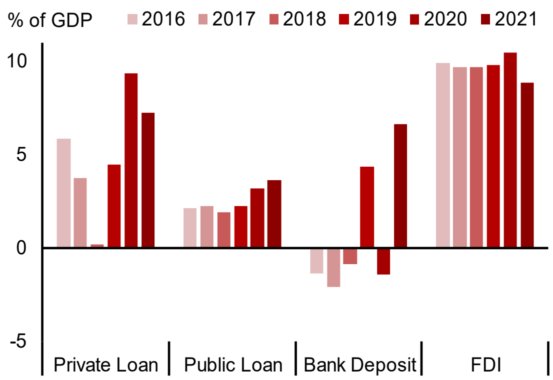
1. **Cambodia's current account deficit has been mainly financed by foreign direct investment (FDI) inflows, while external borrowings and bank deposits from non-residents have increased markedly.** Despite sustained current account deficits, the country's international reserves increased steadily until 2020 (Figure A3.1), owing to to robust capital inflows[51]. FDI remains the largest source, accounting for about one-third of the total inflow in 2021. External loans, particularly private loan and bank deposits, have been increasing in importance compared to five years ago (Figure A3.2).

Figure A3.1 International Reserves



Source: NBC

Figure A3.2 Capital Inflows

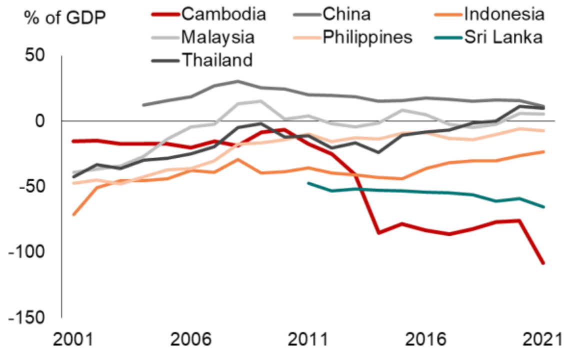


Source: NBC
Note: FDI excludes reinvested earnings.

2. **The persistent current account deficit has led to a rapid deterioration in Cambodia's net international investment positions.** The net **international investment** position as a percent of GDP has deteriorated since 2010, and reached a deficit of 108 percent of GDP as of end-2021. This is substantially lower the deficits seen in regional peers (Figure A3.3). The major share of external liabilities consists of direct investment (152 percent of GDP) and public debt (35 percent) that are mostly long-term and concessional. However, currency and deposits, which can be regarded as short-term borrowings, and banks' external lending, account for 38 percent of GDP (Table A3.1). The composition of external liabilities has changed over time. In 2010, direct investment and lending by the government account for the major share of the external debt. While FDI grew by nearly three times, the increase in public debt has remained modest. Bank deposits and external lending for domestic banks have been increasing (Figure A3.4).

[50] This selected issue is prepared by Yoki Okawa, Economist.
[51] The rise in international reserves are partially driven by the increased required reserves for the foreign currency deposits. Foreign currency deposit more than doubled from 2017 to 2022, and corresponding required reserves increased by USD 2.3 billion.

Figure A3.3 Net International Investment Position



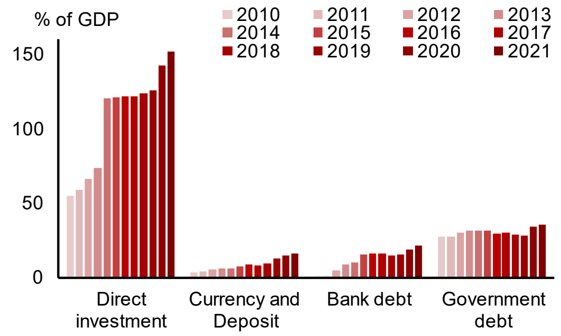
Source: IMF
Note: External Assets minus External Liabilities

Table A3.1 International Investment Position

	Amount (USD bil)	(% of GDP)
Asset	**31.9**	**118**
Currency and Deposit	8.0	30
Official Reserve	20.3	75
Liability	**61.1**	**227**
Direct Investment	41.0	152
Currency and Deposit	4.4	16
Bank debt	5.8	22
Public debt	9.5	35

Source: IMF
Note: As of end-2021. The sum of the categories is not equal to the total amount because only major categories are included in the table.

Figure A3.4 External Liability over Time



Source: IMF

Costs of Financing Current Account Deficits

3. **FDI brings various benefits to the domestic economy.** These benefits include the facilitation of technological transfers, supplementing domestic savings needed for investment, and financing of the current account deficit. In addition, FDI capital flows are less vulnerable to sudden capital outflow than other forms of capital inflows, such as loans and portfolio investment.

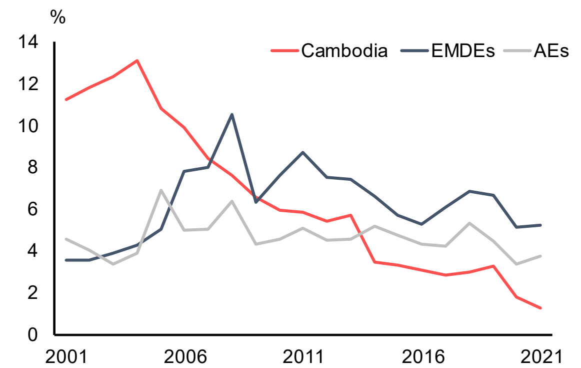
4. **However, the long-term implications of FDI on the external balance vary by industry**, as FDI projects pay dividends to foreign investors from different sources. For projects that rely on foreign demand, such as factories targeting foreign markets, dividend payments are financed by export revenue generated by the project itself, and net effects on the external balance are expected to remain positive. However, for FDI projects that mainly cater to the domestic market, such as residential construction for domestic customers, dividends are paid from revenue in local currency, and the impact on the external balance will be negative due to dividend payments after the initial positive capital inflows[52]. In the long run, as FDI investor starts to recoup their investments, given the high FDI stock in the economy, increasing repatriations of profits in the form of dividend payments may start to put pressures on the external balance.

[52] FDI projects targeting domestic demand and import substitutions such as electricity generation could have different implications on overall external balance. However, the majority of Cambodian FDI targeting domestic sector includes finance, real estate, and construction, which do not substitute imports. Discussion on import substitution channel is omitted for simplicity.

5. **Return on FDI inflow has declined partially due to a large FDI inflows.** Returns on FDI into Cambodia, defined as the ratio of dividend payment to total FDI outstanding, has been on a declining trend since 2004 and has remained below emerging market and developing economies (EMDE) averages (Figure A3.5). In 2021, the return on FDI in Cambodia is 1.3 percent, 4.0 percentage points below the EMDE average return that year. This seemingly low return can be explained by the continued increase in FDI outstanding and an increasing share of young projects in Cambodia. The larger the share of young projects, the lower the average return would be, because profitability of FDI in the first few years tends to be below their peak.[53]

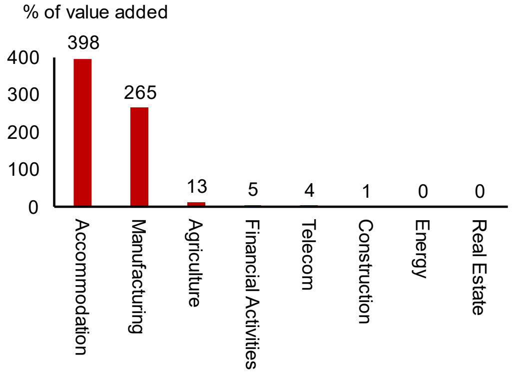
6. **However, from a long-term perspective, Cambodia's high reliance on FDI inflows may have implications on soundness of its external balance, if FDI projects start to yield a higher dividend to foreign investors.** For FDI projects that rely heavily on foreign demand, such as the manufacturing and the tourism accommodation sectors sector (Figure A3.6), dividends can be paid by export revenues generated by the project itself, and net effects on the external balance are expected to remain positive. However, for projects that mainly rely on domestic demand, such as those in the services sector, including real estate, construction and financial sectors, the impact of dividend on the external balance will likely be negative due to dividend payments after the initial positive capital flows. In the long run, an increasing number of FDI projects with a high reliance on domestic markets may start to increase their dividend returns to pay for their investments, comparable to dividend returns in other EMDEs.

Figure A3.5 Dividend Return on FDI



Source: IMF; AMRO staff calculations
Note: Return on direct investment, calculated as the ratio of gross external dividend payment to total FDI liability. Average data from an unbalanced sample of 84 countries. Samples with less than USD 10 billion in FDI liabilities are excluded. EMDEs=Emerging Market and Developing Economies. AEs=Advanced Economies.

Figure A3.6 Share of Export Values to Domestic Value-added, by Industry in 2019

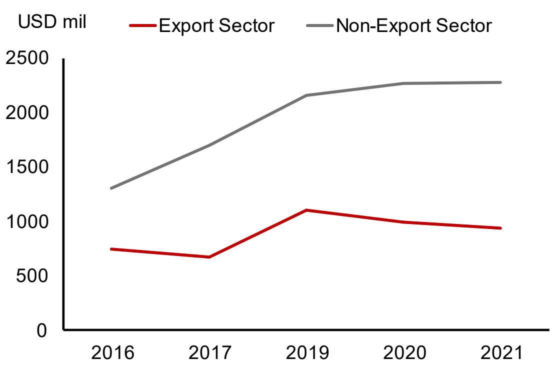


Source: CEIC
Note: Export value over value added for Cambodia. Data from 2019 excludes exclude the impact of COVID-19 on Accommodation Sector. Numbers can exceed 100 percent because export values are in terms of gross revenue, and value-added are valued after netting intermediate inputs.

7. **The increasing share of FDI to the non-export sector[54] may create structural pressure on the current account balance.** The amount of FDI in the non-export sector, including in finance, construction, and real estate, is larger than FDI in the export sector (Figure A3.7). Major non-export sectors include finance (26 percent of total FD stock in 2021), real estate (14 percent), and construction (9 percent). Major export sectors are manufacturing (23 percent) and hospitality (12 percent) (Figure A3.8). FDI to the non-export sectors contributes to GDP and technological transfers, but it will create long-term pressure on the external balance through dividend payments.

[53] In Czech Republic, FDI profitability reaches its peak at the six-year, and the average duration of total investment is 16 years (Novotny, 2018).
[54] For the analysis of this report, the "export sector" is defined as accommodation and manufacturing, and other sectors are defined as the "non-export sector." The mining sector, whose share is less than 2 percent of total FDI, is excluded from the analysis due to the large re-exports of gold.

Figure A3.7 FDI Inflows by Year



Source: CEIC
Note: Based on annual total inward FDI.; The "export sector" is defined as accommodation and manufacturing, and the "non-export sector" includes finance, real estate, agriculture, energy, construction, and telecom.

Figure A3.8 FDI Stock by Export Relevance

Source: IMF
Note: Total FDI liabilities by sector in 2021; The "export sector" is defined as accommodation and manufacturing, and the "non-export sector" includes finance, real estate, agriculture, energy, construction, and telecom.

Policy Implications

8. **External imbalances could create medium- to long-term challenges.** The large current account deficit, the increasing share of external borrowings, and widening net external position deficit suggest that external imbalances could be accumulating. While large international reserves and a well-capitalized domestic banking sector could mitigate the short-term risks to the economy, the accumulation of imbalances could weigh on Cambodia's sustainable growth in the long term. Increasing the share of FDI to non-export sectors could lead to sustained capital outflows as dividends without the corresponding export revenue.[55]

9. **Precautionary actions could reduce the long-term financing costs of FDI inflows, while enhancing its benefits for the overall economy.** While the immediate risk of an external crisis is low, preventive actions could minimize the long-term costs. Policy reforms to increase the attractiveness of Qualified Investment Projects, which mainly target the export sectors, are welcome moves and the incentives for non-export sector FDI such as preferential tax treatment could be adjusted to mitigate the negative impact of dividend outflows on the external balance. In the long term, strengthening the export sector could resolve structural vulnerabilities.

References

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[55] Assuming that Cambodia's dividend return to FDIs increases to the EMDE average level from the 2021 level, the additional capital outflow could be 7.9 percent of GDP per year.

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