AMRO Country Report
ACR/23-11

AMRO Annual Consultation Report

Cambodia - 2023

ASEAN+3 Macroeconomic Research Office (AMRO)

December 2023

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 the 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 September 4 to 14, 2023 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr. Jinho Choi, Deputy Group Head and Principal Economist. Members include Ms. Chunyu Yang, Desk Economist for Cambodia; Mr. Paolo Hernando, Senior Economist; Mr. Jungsung Kim, Economist; Dr. Trung Thanh Vu, Associate Economist; Ms. Sopheawattey San, Associate; and Mr. VansopheaktraOdorm Tep, Associate. AMRO Director Dr. Kouqing Li and Chief Economist Dr. Hoe Ee Khor also participated in key policy meetings with the authorities. This AMRO Annual Consultation Report on Cambodia for 2023 was peer-reviewed by a group of economists from AMRO's Country Surveillance, Financial Surveillance, and Fiscal Surveillance teams; endorsed by the Policy and Review Group; and approved by Dr. Hoe Ee Khor, AMRO Chief Economist.

3. The analysis in this Report is based on information available up to October 20, 2023.

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.

Table of Contents

Executive Summary

1. Cambodia's economy is expected to continue its gradual recovery path in 2023 on the back of a robust tourism recovery and domestic activity. A robust tourism recovery alongside pent-up domestic consumption will sustain the ongoing improvement in the service sectors. Although growth in the garment sector is projected to decelerate in 2023 due to persistently subdued US and EU demand, the non-garment manufacturing sector is likely to continue experiencing high growth. Moving forward, GDP growth is projected to accelerate to 6.2 percent in 2024 from 5.3 percent in 2023.

2. Consumer price inflation is projected to ease in 2023, thanks to the moderation of global oil and food prices. Cambodia's inflation dynamics tend to respond more rapidly to changes in global food and oil prices compared to most ASEAN countries, mainly attributable to the high share of food items in its consumer price index (CPI) basket as well as its heavy reliance on imported oil. For the whole of 2023, headline CPI inflation is projected to decline to 2.6 percent from 5.3 percent in 2022, mainly due to lower global oil prices.

3. The current account deficit is expected to narrow sharply in 2023, mainly reflecting the improvement in trade balances. The current account deficit narrowed significantly to 25.7 percent of GDP in 2022 from 40.4 percent in 2021, and turned into a surplus of 3.4 percent of GDP in H1 2023 on the back of a sudden stop in gold imports, sustained inflows in remittances and a robust recovery in tourism. Moving forward, the current account balance is projected to register a small deficit at 2.6 percent of GDP for the whole year of 2023 on the back of the resumption of gold imports since July, and is expected to widen to 5.1 percent of GDP in 2024, with the increase in demand for imports of goods as the economy continues to strengthen.

4. The Khmer riel has depreciated slightly since May 2023, prompting the resumption of the National Bank of Cambodia's (NBC's) forex interventions from September 2023. The riel remained broadly stable against the US dollar in 2022 and early 2023. However, since May 2023, the riel has been under depreciation pressure against the US dollar, which led to the NBC's forex interventions of USD50 million in September for the first time in 2023, and another USD40 million in October.

5. The real estate sector remains weak due to a combination of cyclical downturn and oversupply. The oversupply situation primarily stemmed from the construction boom and increases in foreign investments during 2018-2019. The contraction in demand in 2022 further exacerbated the oversupply problem, while slower sales and downward pressures on property prices resulted in liquidity problems for developers. In response to the weakness in the real estate sector, the government implemented support measures in April 2023, mainly by postponing or exempting tax payments for Borey developers and home buyers.

6. Credit expansion has slowed down, and the banking sector saw a surge in non-performing loan (NPL) ratio, but the financial sector remains sound with sufficient capital buffer and liquidity. Credit growth moderated from 18.2 percent in 2022 to an average of 12.9 percent (year-on-year) from January to July 2023, driven mostly by the slowdown of loans in the real estate-related sectors, as well as the wholesale and retail trade sectors. The NPL ratio sharply increased to 4.8 percent for banks in July 2023 from 3.1 percent in December 2022. That said, the banking sector remains well buffered with capital adequacy ratio at above 20 percent. The liquidity coverage ratio for banks stood at 159 percent in July 2023.

7. The fiscal deficit is expected to widen to 6.2 percent of GDP in 2023 due to higher spending, before steadily declining based on the fiscal consolidation plan. The widened fiscal deficit is

mainly driven by higher fiscal stimulus due to the expansion of the cash transfer program to "near-poor" households and flood-hit communities, civil servant wage increase, as well as investment projects on digital and green infrastructure. According to the fiscal consolidation plan, the fiscal deficit in 2024 is set to shrink to 3.2 percent of GDP, but will remain higher than pre-pandemic level with the integration of the COVID-19 cash transfer program into a permanent 'Family Package' program, which is targeted at the poor and vulnerable households. Going forward, steady improvements in revenue and a reduction in domestically financed capital expenditure to near pre-pandemic levels, will help narrow the fiscal deficit to 2.6 percent of GDP by 2026.

8. Cambodia's path toward a strong economic recovery could be derailed by several near-term external risks and domestic vulnerabilities. A faltering economic recovery in China, a weaker global economic recovery due to higher-for-longer US interest rate, and a renewed surge in global oil and food prices, could exert downward pressure on Cambodia's highly open and dollarized economy through trade and investment channels. Meanwhile, domestic vulnerabilities remain, including a prolonged weakness in the real estate sector and the inherent risks linked to shadow banking activities, as well as potential weakness in the structure of financial account. As a perennial risk, natural disasters and climate change transition could lower potential growth unless effectively addressed.

9. Restoring fiscal space should remain a policy priority, involving the complete phasing out of pandemic-related stimulus and counter-inflationary measures. The lessons learned from the pandemic have highlighted the importance of maintaining adequate fiscal space, which allows the authorities to respond effectively to unforeseen shocks. A strong fiscal position is essential to sustain confidence in a highly dollarized economy. Additionally, the limited capacity for borrowing from capital markets further underscores the importance of this policy. Boosting revenue and augmenting spending effectiveness are vital to enhance fiscal space and medium-term fiscal sustainability.

10. The pace of the NBC's normalization of its monetary and macroprudential policy measures should be gradual and cautious, while the supervision on bank and non-bank sectors should be further strengthened. The ongoing global financial tightening with a reduction in US dollar liquidity could have an adverse impact on the domestic financial system, hence the NBC should remain flexible in adjusting its reserve requirement ratios for foreign currencies and/or the capital conservation buffer, especially if market conditions were to worsen significantly. In the meantime, the financial supervisory framework and domestic financial safety net could be further strengthened. Tightening the regulatory oversight and supervision of the unregulated shadow banking activities is critical to mitigate the risks stemming from a prolonged real estate downturn.

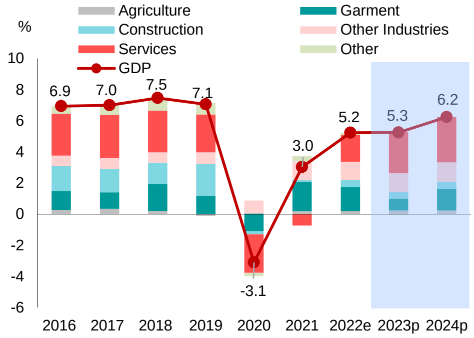
11. Under the new government, a steadfast commitment to structural reforms remains crucial to sustain the momentum of economic growth. This includes diversifying the economic structure, particularly in the manufacturing sector, accelerating the diversification of tourism products, enhancing the skill sets of the current workforce, addressing the ongoing challenge of high logistics costs, enhancing SME financing through the introduction of digital lending options, implementing comprehensive climate change measures while addressing medium-term transition risks, and continuing adoption of emerging technologies and promotion of the digital economy. The new government's key policy roadmap, including the Pentagonal Strategy, should serve as a fundamental step in building social consensus and implementing structural reforms.

A. Recent Developments and Outlook

A.1 Real Sector Developments and Outlook

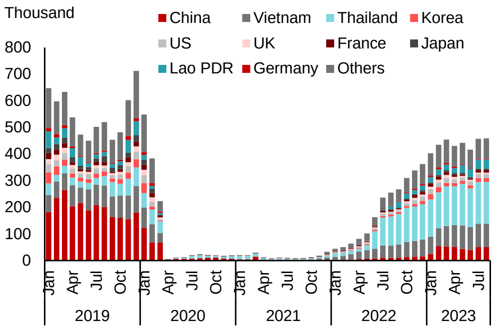
1. Cambodia's economy continued to recover robustly in 2022 and the first half of 2023. Cambodia grew by 5.2 percent in 2022, mainly driven by strong external demand, especially for garments, and a resumption of domestic activities (Figure 1). Since the beginning of 2023, the growth drivers have shifted to the service sectors due to a sharp pick-up in foreign tourist arrivals, which reached 3.5 million in August, approaching 80 percent of pre-pandemic levels (Figure 2). The agricultural sector also rebounded steadily, benefiting from enhanced access to regional markets, particularly to China, Korea, and Vietnam, thanks to newly signed bilateral and multilateral free trade agreements (FTAs). However, the manufacturing sector struggled with external headwinds, primarily weak demand in the US and EU markets, which account for nearly two thirds of total exports. Garment exports contracted by 17.6 percent during the first three quarters of 2023, which was partially offset by robust shipments in other manufacturing industries, including electrical, electronic, and vehicle parts. The construction sector continued to recover, but at a slow pace, as some segments of the residential housing markets faced oversupply problems, while the progress in infrastructure projects remained on track.

Figure 1. Contribution to Real GDP Growth



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

Figure 2. International Tourist Arrivals

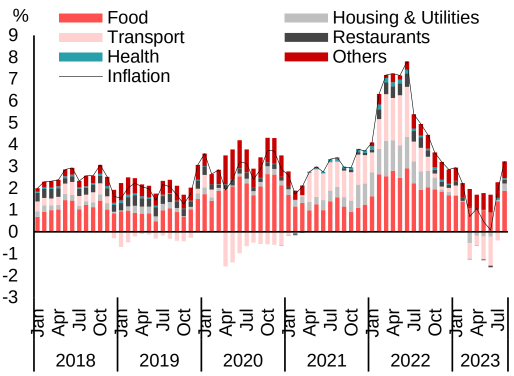


Source: Ministry of Tourism (MOT)

2. Moving forward, the economy is expected to continue its gradual recovery path with projected growth of 5.3 percent in 2023 and 6.2 percent in 2024. A robust tourism recovery, supported by increased flight availability and the return of foreign tourists, alongside pent-up domestic consumption, will sustain the ongoing improvement in the service sectors. Growth in the garment sector is projected to decelerate in 2023 due to persistently subdued US and EU demand and the high base effect from a strong recovery for 2022, but is expected to partially recover in 2024. The non-garment manufacturing sector is likely to continue its high growth, gradually expanding its share in the economy from the current low base. Continued improvement in foreign direct investment (FDI) inflows, resulting from the recently established FTAs, enhanced incentives under the new Law on Investment, and infrastructure support, will fuel Cambodia's investment.

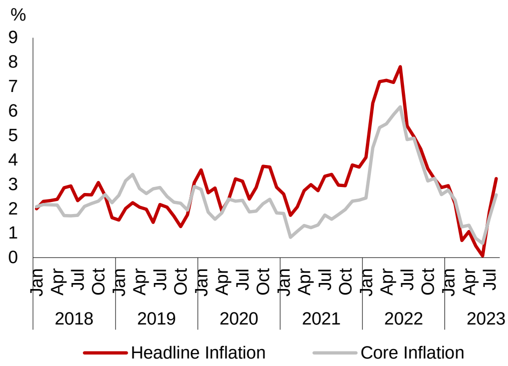
3. Consumer price inflation spiked to an annual average of 5.3 percent in 2022 and eased significantly in the first half of 2023. Cambodia's inflation dynamics tend to respond more rapidly to changes in global food and oil prices compared to most ASEAN countries, mainly attributable to the significant share of food items in its consumer price index (CPI) basket, accounting for 45 percent, as well as its heavy reliance on imported oil. In 2022, headline inflation reached its peak in June at 7.8 percent year-on-year (yoy), driven by a sharp increase in global commodity prices following the outbreak of the Ukraine crisis, before decelerating in the second half, to 2.9 percent in December, thanks to the easing of global oil and food prices (Figure 3). During the first half of 2023, headline inflation continued its decline, averaging 1.2 percent, reflecting a 6.3 percent reduction in energy prices. Food prices rose moderately by 2.6 percent during the same period. Core CPI inflation, excluding food and energy, declined from 4.4 percent in 2022 to an average of 1.5 percent in the first half, primarily due to the high base from the previous year. However, starting from July 2023, the inflation saw a pickup trend (Figure 4), partly reflecting the base effect of last year as well as the tightening of global rice supplies after India's export ban. For the whole of 2023, headline CPI inflation is projected to decline to 2.6 percent from 5.3 percent in 2022, mainly due to lower global oil prices for the first eight months of the year, before picking up to 3.1 percent in 2024, in tandem with stronger economic growth.

Figure 3. Contribution to Inflation (by Major Categories)



Source: NIS; AMRO staff calculations

Figure 4. Headline and Core Inflation



Source: NIS; AMRO staff calculations

4. The real estate sector remains weak due to a combination of cyclical downturn and oversupply. Tighter financial conditions for real estate developers, and weaker demand for residential properties, are among the key factors contributing to the prolonged weakness. The oversupply situation primarily stemmed from the construction boom and increases in foreign investments during 2018-2019. Amid the pandemic-induced economic slowdown in 2022, the contraction in demand further exacerbated the oversupply problem, while slower sales and downward pressures on property prices resulted in liquidity problem for developers. While the residential property price index (RPPI) published by the NBC has shown an ongoing recovery in housing prices since May 2022, tensions have arisen between home buyers and real estate developers, mainly due to disputes over land ownership and house confiscation stemming from delayed payments. In response to the weak real estate sector, the government implemented support measures in April 2023, mainly by postponing or exempting tax payments for Borey developers and home buyers, and encouraging banks to restructure loans for Borey developers.[1]

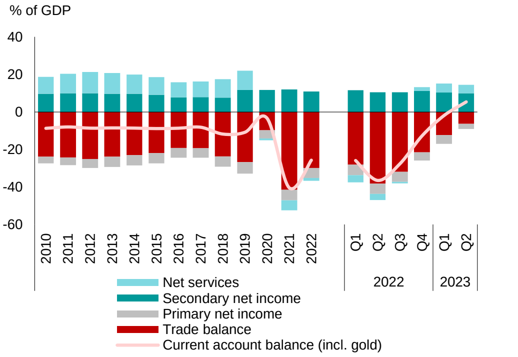
A.2 External Sector and the Balance of Payments

5. The current account deficit narrowed significantly to 25.7 percent of GDP in 2022, before turning into a surplus in H1 2023, mainly reflecting the improvement in the trade and services balances. In 2022, the trade deficit narrowed sharply to 29.8 percent of GDP

[1] "Borey" is a term used in Cambodia to denote a specific type of residential housing in Cambodia, referring to gated housing communities that have gained popularity among Cambodians. Some tax support measures include: (i) delaying the implementation of the capital gains tax until the end of 2024, (ii) exempting stamp duty tax on the transfer of ownership with a value less than USD70,000 until the end of 2024, and (iii) extending the deadline for tax payment from 2 to 18 months for property developers who pay less than USD1 million in taxes and from 24 to 36 months for those who pay over USD1 million in taxes.

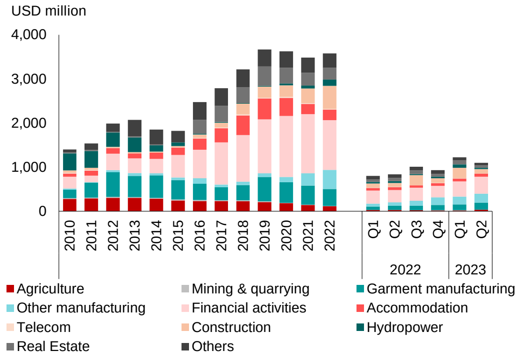
from 41.2 percent in 2021, due to a strong recovery of garment exports and a decline in gold imports.[2] Excluding gold trades, the current account deficit improved to 11.3 percent of GDP in 2022 from 18.9 percent in 2021. In H1 2023, the current account turned into a surplus of 1.7 percent of GDP[3] on the back of a sudden stop in gold imports,[4] sustained inflows in remittances and a robust recovery in tourism (Figure 5). Meanwhile, despite global financial tightening, FDI inflows remained resilient, at 11.6 percent of GDP in 2022 and 14.1 percent in H1 2023 (Figure 6). As a result, the overall balance registered a surplus of 1.2 percent of GDP in 2022, and 1.6 percent of GDP in H1 2023, though an outflow in bank deposits abroad was observed (Figure 7). Gross international reserves declined from USD20.3 billion in 2021 to USD17.8 billion in 2022, partly due to the valuation effects from a stronger US dollar, higher interest rates, and a drawdown in forex reserves by banks. Moving forward, the current account balance is projected to register a small deficit of 2.6 percent of GDP for the whole of 2023 on the back of the resumption of gold imports since July, and is expected to widen to 5.1 percent of GDP in 2024, with the recovery in demand for imported goods as the economy strengthens.

Figure 5. Current Account Balance



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

Figure 6. FDI Inflows by Sector

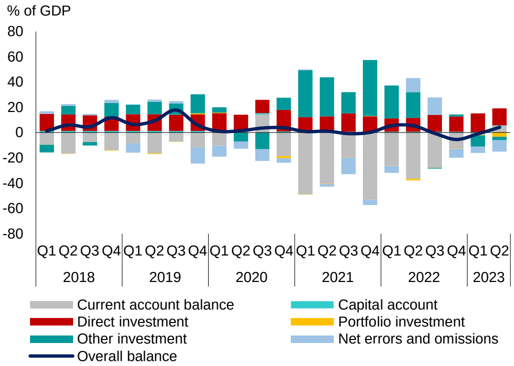


Source: NBC; AMRO staff calculations

6. **The Khmer riel remained broadly stable against the US dollar in 2022 and early 2023, but has depreciated slightly since May 2023.** Despite the US dollar's global strength against major currencies, the riel only marginally depreciated, and the NBC has seldom conducted forex interventions since the beginning of 2022. However, since May 2023, the riel has been under depreciation pressure against the US dollar, which led to the NBC's forex interventions of USD50 million in September for the first time in 2023, followed by another USD40 million in October (Figure 8).[5] In addition, since August 2022, the official exchange rate has been fully in line with the market exchange rate, as the NBC adopted a new calculation method which takes the weighted average of interbank market rates in determining the official exchange rate on a daily basis.[6]

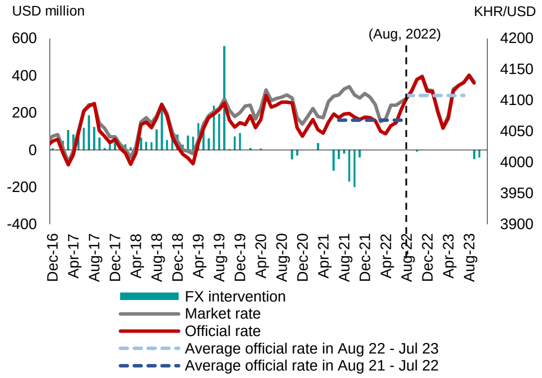
[2] According to AMRO (2022), mirror trade data indicates that there has a large volume of gold trades in Cambodia even prior to 2020, though they were not recorded in the official trade statistics. During the pandemic, stricter border controls resulted in an improved ability to capture gold trading data. Meanwhile, surging gold prices encouraged speculative investment. Therefore, large and volatile gold trading has been observed in 2020-2022 and became a key driver behind the current account balance. See https://www.amro-asia.org/amros-2022-annual-consultation-report-on-cambodia/
[3] Nominal GDP figures are based on AMRO staff projections.
[4] In Cambodia, gold exporters and importers are required to obtain permits from the NBC for each gold trade transaction. Starting in December 2022, the NBC suspended the issuance of permits for gold imports and began gradually issuing them again in July 2023. As a result, no official gold imports were recorded from December 2022 to June 2023.
[5] Another factor that caused the Khmer riel depreciation is that the Ministry of Economy and Finance recently shifted the government savings from the NBC to commercial banks, in consideration of better revenue management, resulted in additional liquidity injections of the riel to the market.
[6] Previously, the NBC's official exchange rate was based on the bidding and asking prices of foreign exchange rates against the KHR for NBC transactions with third parties. Starting from August 2022, the NBC has decided to determine the official exchange rate by calculating the weighted average exchange rate of the actual daily exchange transactions on the NBC platform.

Figure 7. Balance of Payments



Source: NBC; AMRO staff calculations

Figure 8. The Exchange Rate of Khmer Riel to US Dollar and NBC's Forex Interventions

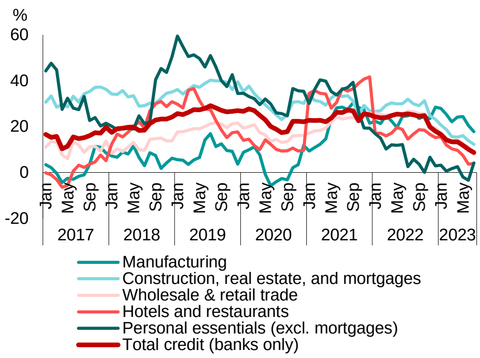


Source: NBC

A.3 Monetary Condition and Financial Sector

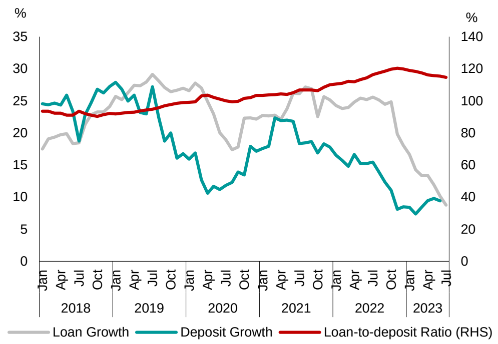
7. Credit expansion continued to slow down amid the tightening global financial conditions. Credit growth moderated from 18.2 percent in Dec 2022 to 9.1 percent (yoy) in July 2023[7], driven mostly by the slowdown of loans in the real estate-related sector, as well as the wholesale and retail trade sector (Figure 9). Still, the credit-to-GDP ratio remained high, exceeding 170 percent. Meanwhile, the loan-to-deposit ratio stands above 100 percent, surpassing pre-pandemic levels (Figure 10). Tighter competition for deposits among banks, complicated by the global tightening condition, has pushed up US dollar deposit interest rate to 5.8 percent in June 2023 from an average of 3.8 percent in Jan-April 2022 and 4.6 percent in May-December 2022. The higher cost of funding has resulted in an increase in the US dollar lending rate to 10.1 percent in January 2023, before retreating to 8.6 percent in June 2023.

Figure 9. Credit Growth (Bank Only)



Source: NBC; AMRO staff calculations

Figure 10. Loan-to-Deposit Ratio (Bank Only)



Source: NBC; AMRO staff calculations

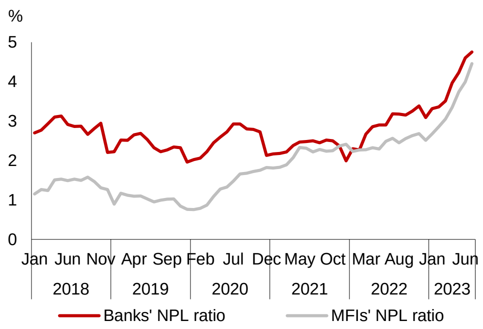
8. The banking sector remains resilient with capital and liquidity buffers well above minimum regulatory requirements, despite asset quality deteriorating, notably with the expiry of the regulatory forbearance. The non-performing loan (NPL) ratio sharply increased to 4.8 percent for banks and 4.5 percent for microfinance institutions (MFIs) in July 2023 from 3.1 percent and 2.5 percent in December 2022 (Figure 11), respectively, as banks reclassified restructured loans as per the NBC's instruction.[8] By industry, the NPL ratio in the

[7] This refers to the credit distributed to the non-financial institutions by banks only. For the total credit distributed to both financial and non-financial institutions by banks and microfinance institutions, the growth rate moderated from 18.8 percent in December 2022 to 9.0 percent in July 2023.

[8] The loan structuring program finished in June 2022, and banks were required to gradually assess and reclassify loans based on the loan quality.

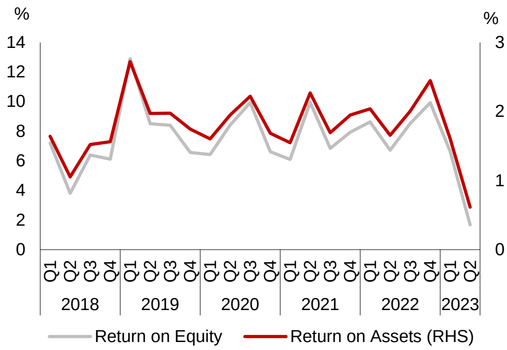
hotel and restaurant sector increased to 11.8 percent in June 2023, after a surge from 3.1 percent in December 2021 to 9.0 percent in December 2022. Similarly, the NPL ratio in the real estate sector stood at 5.4 percent in June 2023, making it one of the sectors with the highest NPL ratios.[9] That said, the banking sector remains well buffered with capital adequacy ratio at above 20 percent.[10] The liquidity coverage ratio for banks and deposit-taking MFIs stood at 159 percent and 285.7 percent in July 2023, respectively, as compared to the 100 percent minimum threshold. The provision coverage ratio of the banking system increased to 144.8 percent in 2022 from below 100 percent in 2021, thanks to the more stringent requirements set by the NBC. Increased provision expenses, coupled with higher funding cost and increased capital, contributed to a decline in banks' return on assets and return on equity, which stood at 0.6 percent and 1.7 percent, respectively, in Q2 2023 (Figure 12).

Figure 11. Non-performing Loan Ratio



Source: NBC; AMRO staff calculations

Figure 12. Profitability



Source: NBC

9. The NBC is gradually restoring the reserves requirement ratios (RRRs), while ensuring sufficient liquidity through monetary operations. The NBC increased the allotment of the liquidity-providing collateralized operation (LPCO) to meet the demand for riel liquidity in the market. As a result, the outstanding LPCO expanded to KHR1.5 billion in July 2023, up 44.3 percent (yoy) (Figure 13). Meanwhile, the NBC increased the RRR in foreign currencies to 9 percent in January 2023, up from 7 percent during the pandemic, and will continue increasing the RRR to the pre-pandemic level of 12.5 percent in December 2024[11], while maintaining RRR for local currency at 7 percent (Figure 14). To bolster the resilience of the banking system, the NBC requires banks to gradually build up capital conservation buffer (CCB).[12] Besides, to align with the Basel III standards, two regulations have been recently announced to enhance the criteria for calculating the CAR.[13]

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[9] The NPL ratios for the hotel and restaurants and real estate activities in June 2023 are calculated by AMRO staff. According to the NBC, the hotel and restaurant sector accounts for 11 percent of total NPLs, while the construction sector contributes 10 percent.

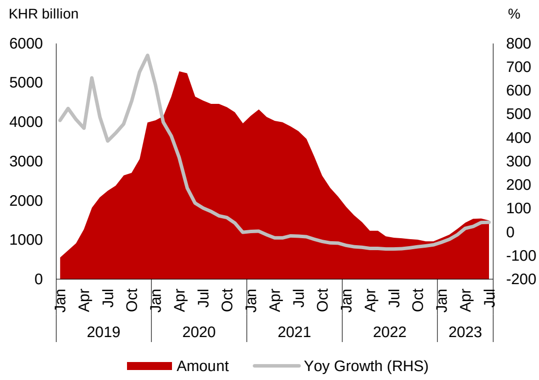
[10] According to AMRO staff's reverse stress test results, even when the NPL ratio raises to 6.8 percent, the CET1 ratio and CAR will still be above 17 and 20 percent, respectively. See [AMRO (2022) at https://www.amro-asia.org/amros-2022-annual-consultation-report-on-cambodia/](https://www.amro-asia.org/amros-2022-annual-consultation-report-on-cambodia/) for the details.

[11] Initially the NBC planned to raise the RRR in foreign currencies to 12.5 percent in January 2024. On November 23, 2023, the NBC communicated to banks that the planned increase would be postponed, and it is now scheduled for December 2024.

[12] According to an announcement to banks and financial institutions (BFIs) dated on January 9, 2023, BFIs are required to maintain CCB at 1.25 percent by June 30, 2023, and at 2.5 percent by December 31, 2023. However, the countercyclical buffer (CCyB) is maintained at zero percent.

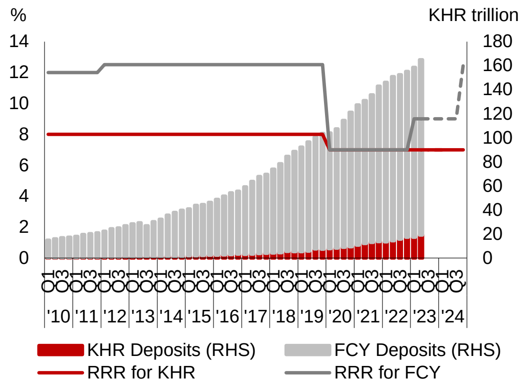
[13] The first regulation updated the classification of Tier 1 and Tier 2 capital and divided Tier 1 capital to Common Equity Tier 1 and Additional Tier 1. The second regulation provided more detailed credit risk classification with specific requirements for different asset risk weights. Three additional regulations are set to be announced in 2023, addressing market risk, operational risk, and new capital adequacy requirements, respectively.

Figure 13. Outstanding LPCO



Source: NBC; AMRO staff calculations

Figure 14. Reserve Requirement Ratios and Deposits by Currency

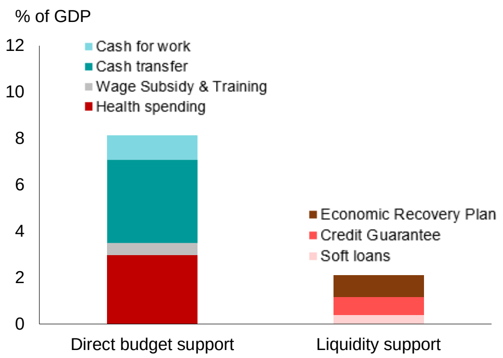


Source: NBC; AMRO staff calculations

A.4 Fiscal Sector

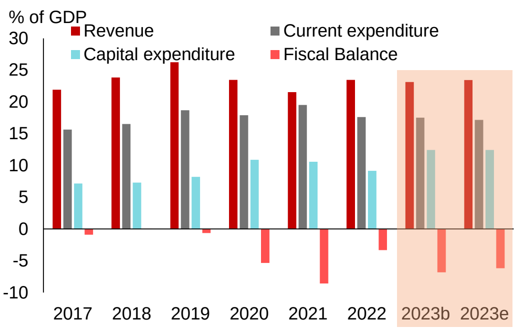
10. The government adopted additional fiscal measures to support the economic recovery in 2022 (Figure 15). To effectively respond to the pandemic and inflationary pressure, the government took measures to provide targeted support to the economy. The tourism sector was supported through a tourism recovery co-financing scheme, and continuing tax and fee holidays. Various tax measures were also implemented in 2022 to help boost demand.[14] A new cash transfer for "near-poor" households was also introduced to help mitigate the impact of high inflation (see Box A "The Evolution and Future of Cash Transfer Programs in Cambodia").

Figure 15. Fiscal Support 2020-2022



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

Figure 16. Fiscal Balance



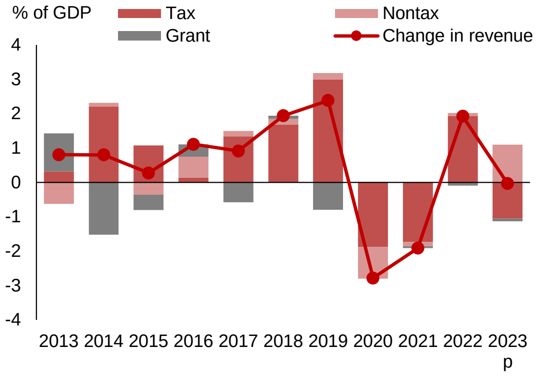
Source: MEF; AMRO staff calculations
Note: b = budget law; e = estimation

11. The fiscal deficit narrowed in 2022 (Figure 16) with the partial withdrawal of pandemic stimulus measures and a strong recovery in revenues. Fiscal revenue grew by 19.3 percent in 2022, in contrast to the contraction during the pandemic (Figure 17). The strong revenue collection in 2022 was broad-based across all taxes, with the largest contribution from corporate tax and VAT in line with the economic recovery. Initiatives to improve tax administration through Revenue Mobilization Strategy 2019-2023 have proceeded according to the plan, despite the pandemic. As of the end of 2022, 85 percent of the 90 reform measures have been implemented, with the remainder expected to be satisfactorily completed by this year. Meanwhile, expenditure contracted by 2.6 percent as

[14] These temporary measures include the exemption of stamp duty for the purchase of house under USD70,000, the reduction by 10-15 percentage points on the excise duty rate for the import of automobiles, and the reduction by 10-25 percentage points on the excise duty for various items including automobile parts, furniture, food products, clothes, agricultural products, educational products, fruits and vegetables, electrical parts.

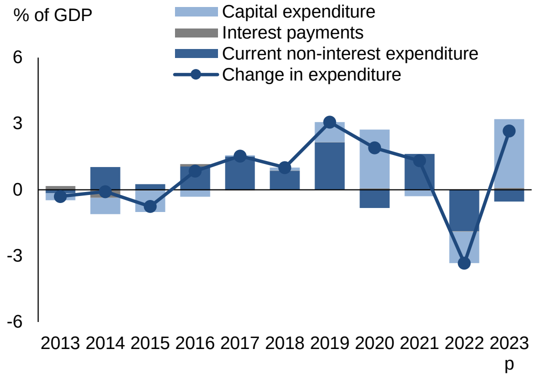
only two-thirds of the pandemic-related stimulus was spent, mainly due to under-utilization in health-related expenditures and project implementation delays (Figure 18). As a result, the fiscal deficit narrowed sharply to 3.3 percent of GDP in 2022 from 8.6 percent in 2021. The narrower fiscal deficit and improved economic growth helped pull down the public debt ratio, which was steadily rising during the pandemic, to 34.0 percent of GDP in 2022. Meanwhile, fiscal reserves marginally rose to about 11 percent of GDP in 2022, following a significant drawdown of over a third during the pandemic period.

Figure 17. Change in Revenue Compared to the Previous Year



Source: MEF; AMRO staff calculations

Figure 18. Change in Expenditure Compared to the Previous Year



Source: MEF; AMRO staff calculations

12. Moving forward, the fiscal deficit is expected to widen again in 2023 due to higher spending, before steadily declining based on the fiscal consolidation plan. The fiscal deficit is expected to widen to 6.2 percent of GDP in 2023, mainly driven by higher fiscal stimulus[15] due to the expansion of the cash transfer program to "near-poor" households and flood-hit communities, civil servant wage increase, as well as investment projects on digital and green infrastructure.[16] According to the fiscal consolidation plan, the fiscal deficit in 2024 is set to shrink to 3.2 percent of GDP, due to the removal of pandemic related fiscal policies and projected strong growth, but will remain higher than pre-pandemic level with the continuation of the cash transfer program. The cash transfer will be institutionalized into a program called "Family Package" from 2024 onward, which is targeted at the poor and vulnerable households, particularly pregnant women, young children, disabled, and elderly. Based on AMRO projections, steady improvements in revenue and reduction in domestically financed capital expenditure to near pre-pandemic levels, will help narrow the fiscal deficit to 2.6 percent of GDP by 2026.

Box A. The Evolution of Cash Transfer Programs in Cambodia[17]

Cambodia's government policy has been geared towards expanding social protection, with cash transfer as one of the primary tools. Cambodia's flagship "Social Protection Policy Framework (SPPF) 2016-2025", lays out the government's strategies to expand coverage, utilize targeted interventions and strengthen institutions, with the goal of enhancing the resilience of vulnerable households to shocks and eventually reducing poverty. Cash transfer schemes was utilized as one of the primary tools to effectively expand targeted interventions.[18] Target beneficiaries

[15] Due to its urgent nature, the fiscal stimulus was recorded as part of capital expenditure for ease of recording during the period 2020-2023. However, from 2024 onward, the regular cash transfer program will be classified as current expenditure in the budget of the relevant line ministries.
[16] Major infrastructure projects in the midst of construction in 2023 include the rehabilitation and repair of National Road 8, construction of building and supporting infrastructure for the National Technical Training Institute, construction of 3 bridges in Koh Kong and Kiry Sakor District, construction of Touk Srov Main Canal, among others.
[17] Prepared by Paolo Hernando, Senior Economist, and Vansopheaktraodorm Tep, Associate.
[18] Other programs include pensions, health insurance, education scholarships, among others.

include the poor and vulnerable households, elderly, persons with disabilities, pregnant women and young children. Prior to the pandemic, the cash transfer program reached around 240,000 beneficiaries.

During the COVID-19 pandemic, the cash transfer program was expanded to mitigate the shock from the unprecedented health crisis on poor and vulnerable households. Realizing the urgent need to protect poor and vulnerable households during the COVID-19 pandemic, the cash transfer program was rapidly expanded from a budget of USD 10 million in 2019 to USD 300 million in 2020.[19] The program was scaled up to the national level with the first round of COVID-19 cash transfers reaching 530,000 households, covering around 2.1 million family members. The budget for the cash transfer program has since risen to USD 400 million in 2023 in line with the expanding coverage, reaching 700,000 households (Table A1).[20]

Table A1: Cash Transfer Program Implementation (as of 24th September 2023)

	Household		Members	Children*	Elderly**	People with disabilities	those with HIV/AIDS	Total Amount (KHR)
	Poor 1	Poor 2						
Urban	1,959	2,622	20,144	431	3,667	2,172	7	1,620,600,000
Suburban	239,426	418,091	2,569,018	100,072	360,430	52,873	2,010	110,530,344,000
Rural	25,585	13,769	170,923	9,210	19,990	5,095	13	12,050,048,000
Households that received the cash transfer	266,970	434,482	2,760,085	109,713	384,087	60,140	2,030	124,200,992,000
	701,452							

Source: Ministry of Social Affairs, Veterans and Youth Rehabilitation
Note: *Ages under 5 years old; **Ages above 60 years old

Leveraging on the lessons during the pandemic, Cambodia will transform the temporary COVID-19 cash transfer into a permanent government program called "Family Package". As the economy steadily recovers from the adverse impact of the pandemic, the government is likewise preparing to wind down the COVID-19 cash transfer program. Having proven an effective tool in helping households absorb shocks during crisis, the government will transition the cash transfer program into a new permanent program called the Family Package. The new Family Package cash transfer program will cover pregnant women and their children under the age of 2, children in primary and secondary schools, persons with disability, the elderly and people living with HIV/AIDS-benefiting around 1.5 million individuals with an annual budget of USD150-200 million.

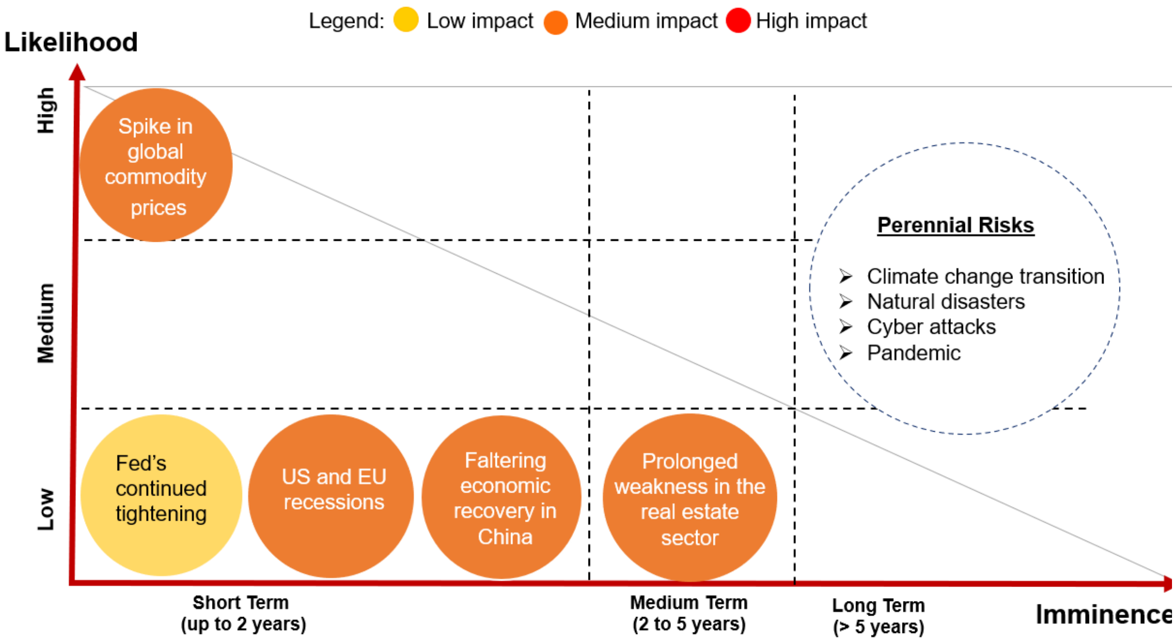
Cash transfer spending will be allocated greater fiscal resources compared to pre-pandemic levels in line with social protection and poverty alleviation objectives. With the end of the pandemic, the budget allocation for the cash transfer will be transferred from the contingency fund to the budget of line ministries, structurally increasing their respective current expenditure. Ongoing reforms to expand the social safety net envisage the seamless integration of social security and social protection under the "life-cycle" approach to enable effective intervention in each stage of life for a more comprehensive social protection strategy.

[19] The cash transfer is disbursed in Khmer Riel. For ease of understanding, we provide the amount in US dollars as a reference.
[20] In addition to the COVID-19 cash transfers for poor and vulnerable households, the government also rolled out other cash transfer programs, particularly: (1) One-time cash transfer program due to COVID lockdowns depending on geographical completed on July 2021; (2) cash transfer program for near-poor as a shock response to high inflation completed on January 2023; and (3) cash transfer program for flood victims according to geographical area completed on March 2023.

B. Risks, Vulnerabilities and Challenges

13. Cambodia's path toward a strong economic recovery could be derailed by several near-term external risks and domestic vulnerabilities. A faltering economic recovery in China, and a weaker global economic recovery due to high-for-longer US interest rate, could exert downward pressure on Cambodia's highly open and dollarized economy through trade and investment channels. A renewed surge in global commodity prices, prompted by heightened geopolitical tensions, and/or severe climate changes, could put upward pressure on inflation in Cambodia. Meanwhile, domestic vulnerabilities remain, including a prolonged weakness in the real estate sector and the inherent risks linked to shadow banking activities, as well as potential weakness in the structure of financial account. As a perennial risk, natural disasters and climate change transition could lower potential growth unless effectively addressed.

Figure 19. Cambodia Risk Map

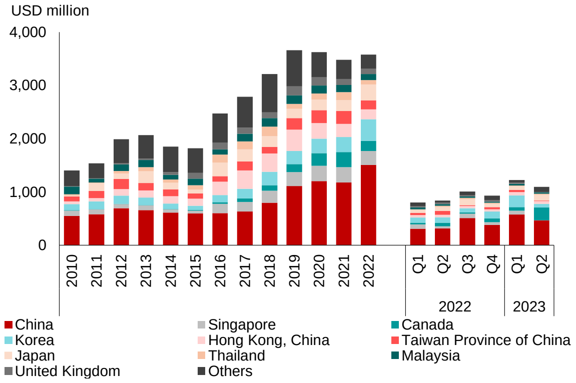


Source: AMRO staff assessment

B.1 Near-term Risks to the Macro Outlook

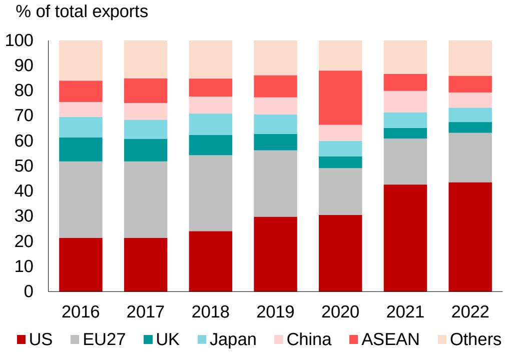
14. External short-term risks mainly stem from a major slowdown of Cambodia's major economic partners and a spike in global energy prices. Cambodia could be adversely affected by faltering economic growth in China, the largest contributor to FDI inflows (Figure 20) and a major source of tourism. Furthermore, an economic recession in the US and EU, possibly induced by high-for-longer interest rates, could significantly dampen Cambodia's growth prospects, as goods exports to the US and EU account for more than 60 percent of total exports (Figure 21), equivalent to more than 40 percent of total GDP. Besides, given that Cambodia's inflation is highly correlated with global commodity prices, a spike in global oil prices, driven by heightened geopolitical tensions, or a surge in global food prices, potentially triggered by a severe El Nino, could cause Cambodia's inflation rate to spike up. This, in turn, could weaken the country's economic recovery.

Figure 20. FDI Inflows by Origin



Source: NBC; AMRO staff calculations

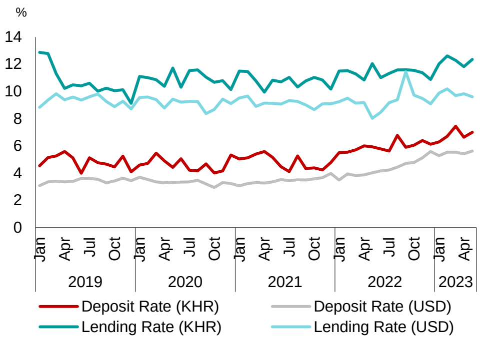
Figure 21. Export by Destination



Source: NBC; AMRO staff calculations

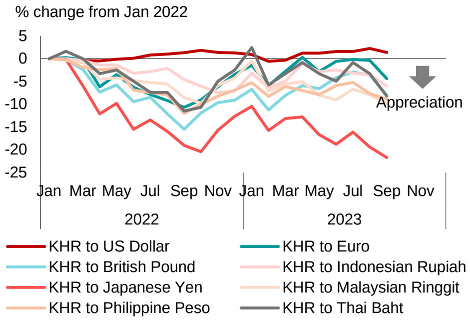
15. A continued global tightening cycle may put pressure on domestic banks' funding costs, and undermine export competitiveness in non-US markets. The likelihood of sudden capital outflows from Cambodia is low, as the majority of capital inflows consist of FDIs and concessional loans from multilateral development banks (MDBs) and official donors, which are stable, and long-term in nature, making them less vulnerable to rising Fed policy rates. However, the rising Fed rates could lead to higher funding costs for banks, considering that most of their overseas funding is based on floating rates. In tandem with the rising deposit rates, banks may experience a squeeze in their profit margins, or they would have to pass the higher funding cost to borrowers through higher lending rates (Figure 22). However, the latter channel is lagging since most loans are based on fixed rates. Meanwhile, the relatively stable exchange rate of the riel against the US dollar means that the riel would appreciate, in tandem with the US dollar, against other currencies (Figure 23), which may adversely affect the competitiveness of Cambodia's goods and services exports.

Figure 22. Interest Rate



Source: AMRO staff calculations
Note: Based on the weighted average rates on term loans and deposits.

Figure 23. Exchange Rate to Selected Currencies



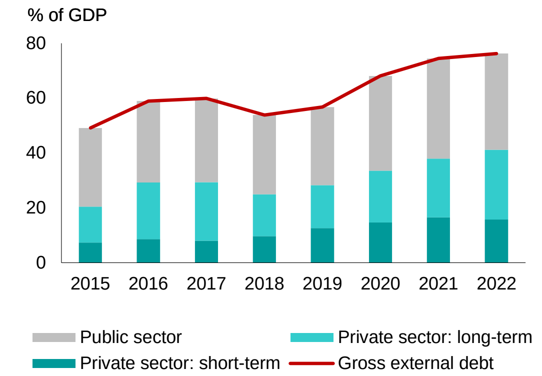
Source: NBC; AMRO staff calculations

16. A prolonged weakness in the real estate sector could lead to financial distress and put pressure on the financial sector and the broader economy. Although the policy measures introduced in April 2023 to support real estate developers and home buyers could provide some reliefs, underlying structural challenges remain and risks are still significant. First, there is a potential for credit risk to escalate well beyond the pre-pandemic levels. Banks could face a further surge in NPLs in 2023 as compared to 2022. Furthermore, shadow banking activities between real estate developers and home buyers have heightened credit risks due to lax credit assessments.[21] The interconnectedness between banks and real estate developers can cause credit risk to be transferred from shadow banking to banks. Second, home buyers and developers can face liquidity problems when they encounter difficulties in liquidating their real estate assets. At the same time, the unregulated shadow banking activities can exacerbate these liquidity challenges.[22] Third, a prolonged real estate downturn could have negative spillovers to the overall economy. Home buyers, particularly those engaged in shadow banking, may face property confiscation due to delayed payments or defaults, which will, in turn, depress their consumption (see Annex 1 "Navigating Double Challenges: Real Estate Downturn and Hidden Risks of Shadow Banking in Cambodia").

B.2 Longer-term Challenges and Vulnerabilities

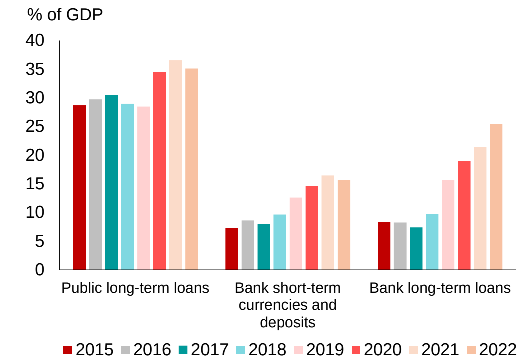
17. Cambodia's financial account faces potential reversal risk in short-term funds due to a growing reliance on short-term external debt and non-resident bank deposits. Cambodia records a persistent trade deficit, due to its heavy reliance on imports of consumption and investment goods, which contributes to persistent current account deficits. While the bulk of these current account deficits were financed by long-term inflows such as FDIs, there has been an increase in short-term capital inflows as reflected in rising external private debt and non-residents' bank deposits over the past five years (Figure 24 and 25). The external private debt increased to 40.9 percent of GDP in 2022 from 24.9 percent in 2018, among which the short-term bank currency and deposits rose to 15.6 percent of GDP from 9.6 percent during the same period. Although the likelihood of a shock reversing these flows is small in the near term, such an event could affect forex liquidity, investors' confidence, and economic growth. It could also lead to a drawdown of foreign exchange reserves.

Figure 24. Gross External Debt over Time



Source: NBC; AMRO staff calculations

Figure 25. Gross External Debt by Sector



Source: NBC; AMRO staff calculations

18. Climate change-induced physical risks can curtail economic activities, while transition risks serve as medium-term growth constraints. Extreme weather events triggered by climate change mainly dampen agricultural output and tourism by disrupting production and transportation networks. Considering that natural disasters in Cambodia comprise mostly floods, the potential inundation of farmlands and vital agricultural facilities, roads, and ports could significantly curtail the activities of those industries. In the medium term, the cost of transitioning to environmentally sustainable practices might pose challenges to the economy if the adaptation to climate-related changes lags behind.

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21 In this context, "shadow banking activities" refer to the situation that real estate developers are engaged in credit provision (mortgage loans) or are extending installment options to home buyers, which are not subject to the supervision of the NBC. According to the NBC, credit to the real estate, construction, and mortgage sectors accounted for about one-third of total bank loans at the end of 2022.

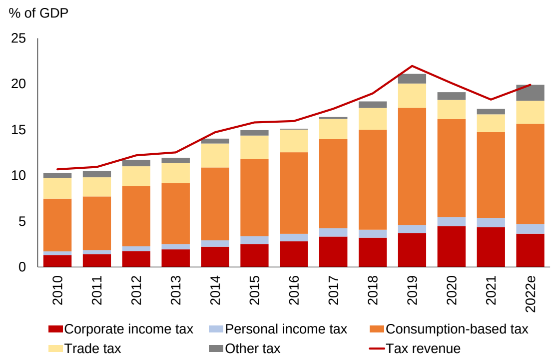
22 For instance, unregistered developers engaged in informal lending may accumulate unchecked debts, making them vulnerable to a drying up of short-term funding during a market downturn.

C. Policy Discussions and Recommendations

C.1 Rebuilding Fiscal Buffers

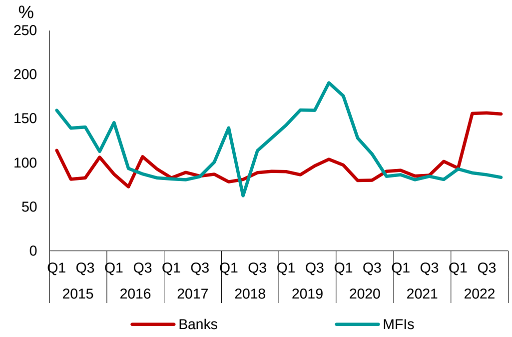
19. Restoring fiscal space should remain a policy priority, involving the complete phasing out of pandemic-related stimulus measures. With the expected removal of short-term stimulus measures by the end of 2023, the focus in 2024 should be on fiscal consolidation and improving the long-term growth prospects of the economy, by accelerating economic diversification and competitiveness, improving social protection, and enhancing infrastructure. The lessons learned from the pandemic have highlighted the importance of maintaining adequate fiscal space, which allows the authorities to respond effectively to unforeseen shocks. Cambodia's commendable history of fiscal discipline, which facilitated the accumulation of fiscal reserves, should be upheld. A strong fiscal position is essential to sustain confidence in a highly dollarized economy. Additionally, the limited capacity for borrowing from capital markets further underscores the importance of this policy. In this context, all pandemic related measures should be phased out now that the economy is recovering robustly, though the cash transfer program should be retained in the form of the Family Package to provide social safety net to the poor and vulnerable groups. In this regard, the government should push ahead with plans to continue offering targeted assistance for the most vulnerable groups of society within a comprehensive framework of social protection. Moreover, the government's new scheme to allocate 2-4 percent of current revenue for the newly established contingency fund is highly commendable as it will help rebuild the fiscal buffer. The combination of fiscal consolidation and enhanced growth prospects is expected to slow the pace of the debt increase, with the debt-to-GDP ratio stabilizing at 35.8 percent in 2025 and then fall to 35.5 percent in 2026. In this regard, Cambodia is assessed to be at a low level of public debt sustainability risk (see Appendix 5 Debt Sustainability Analysis).

Figure 26. Cambodia's Tax Revenue over Time



Source: MEF; AMRO staff calculations

Figure 27. Provision Level



Source: NBC; AMRO staff calculations

20. Boosting revenue and augmenting spending effectiveness are vital to enhance fiscal space and medium-term fiscal sustainability. Tax administration reforms have proven successful in increasing tax revenue through Revenue Mobilization Strategy 2014-2018 (RMS I) and RMS 2019-2023 (RMS II) (Figure 26). However, the government may be reaching the limits of what can be achieved through improvements in tax administration alone, which underscores the need for a complete review of the tax system in preparation for the next phase of tax reforms under RMS 2024-2028 (RMS III). Given a lack of a comprehensive personal income tax system and its relatively low share to total tax revenue, the newly adopted medium-term policy framework for implementing a personal income tax system is commendable (see Annex 2 "Implementing a Comprehensive Personal Income Tax System in Cambodia"). Although the implementation of a capital gains tax on real estate properties, which has already been delayed twice, is now scheduled for January 2025, the authorities should be mindful of possible adverse impacts on the already weak real estate sector. Moreover, an increase in revenue collection should be accompanied by enhanced spending efficiency. This would involve measures such as implementing performance-based budgeting and expediting the disbursement of capital expenditure. As the government eyes an upswing in projects focused on infrastructure, transport, and digital connectivity, there exists a pressing need to bolster the public sector's capacity in investment planning, budgeting, implementation monitoring, and conducting post-implementation reviews.

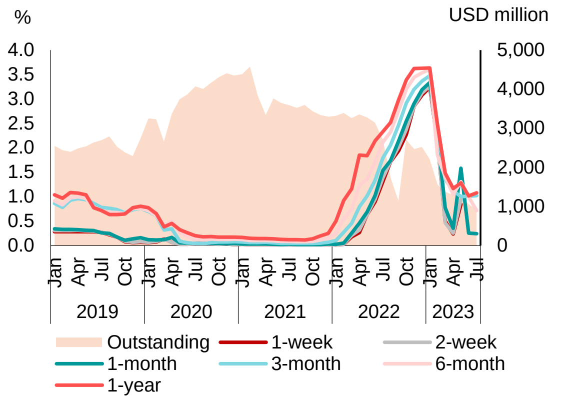
21. Cambodia's reform of social protection system has steadily progressed, with future efforts needing to carefully balance its comprehensiveness and inclusivity with long-term sustainability. The implementation of the National Social Protection Strategy (NSPS) 2016-2025 has helped strengthen and expand Cambodia's social protection system, with the introduction of targeted cash transfer, expansion of healthcare coverage to poor households, and establishment of statutory pension arrangements for formal workers. In particular, the COVID-19 cash transfer program has been found to have significant positive impact, shielding the most vulnerable from income shocks, and ensuring food security during the pandemic.[23] Amid the steady progress, a good balance needs to be maintained between expanding social protection and ensuring fiscal sustainability, as the actual social spending will be higher than the pre-pandemic level with the introduction of the "Family Package". In this regard, the design of new programs on cash transfer, healthcare, and social protection, needs to carefully consider the efficient management and fiscal sustainability of the programs, with the goal of achieving a comprehensive and inclusive social protection system. As the 10-year period for the current strategic framework for social protection will end in 2025, an evaluation of the accomplishment and progress will help inform future investments in social protection.

C.2 Normalizing Monetary and Macroprudential Policy Measures

22. The NBC's stance toward gradual normalization of its monetary and macroprudential policy measures is appropriate, while the pace of adjustments should be cautious. With the subsiding of the COVID-19 pandemic and the robust recovery of the economy, the NBC has initiated a gradual normalization of its policy measures, including adjustments to reserve requirements and capital buffers. However, considering the ongoing global financial tightening, a reduction in US dollar liquidity could have an adverse impact on the domestic financial system. Hence, the NBC should remain flexible in adjusting its RRR for foreign currencies and/or the CCB, taking into consideration developments in market conditions. It is important to maintain the stability of the riel and public confidence, particularly for residents in rural areas. That said, to strike the right balance between the exchange rate stability and foreign reserve adequacy, the NBC should intervene in the market judiciously to minimize excessive volatility. Meanwhile, several steps have been taken to foster development of the interbank money markets, including introducing auctions of NCDs to help manage excess liquidity (Figure 28 and 29), increasing the frequency of the LPCO auctions for injecting liquidity to a weekly basis, launching the NBC platform for facilitating interbank transactions for foreign currencies and government bonds, as well as adjusting the formula for setting the official exchange rate. Introducing an official policy rate and a full-fledged interest rate corridor will help banks to manage liquidity better in the interbank market as participants can obtain short-term funding from each other at reasonable rates.

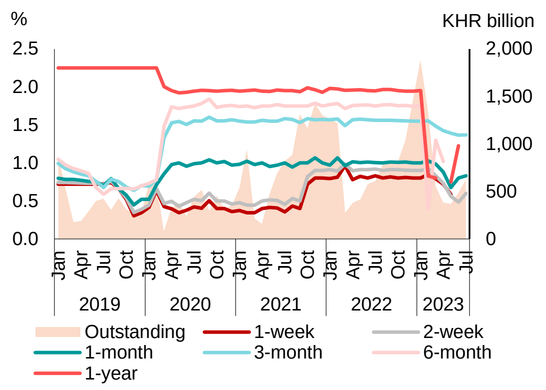
[23] "Socioeconomic Impacts of the COVID-19 Cash Transfer Programme in Cambodia: Micro and Macro-level Evaluations" (UNDP, May 2022)

Figure 28. USD-Denominated NCD Rates and Outstanding Amount



Source: NBC

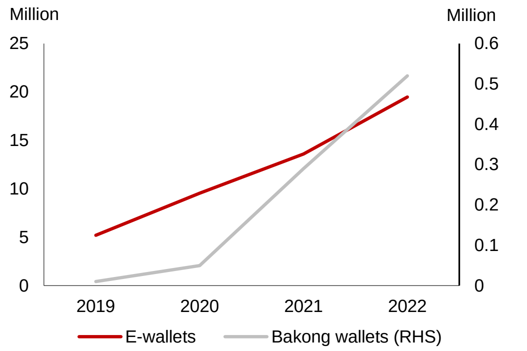
Figure 30. KHR-Denominated NCD Rates and Outstanding Amount



Source: NBC

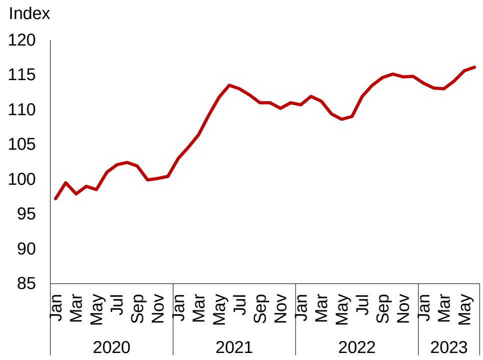
23. AMRO welcomes the NBC's initiatives to enhance financial resilience and its efforts to strengthen the soundness of the financial sector. The introduction of two new regulations in June 2022, pertaining to regulatory capital and credit risk for CAR, is a commendable step to fortify the strength and resilience of banks and deposit-taking MFIs, while also providing guidance for the distribution of loans. Facilitating timely communication and providing clear instructions to market participants, particularly smaller banks, is vital for the successful implementation of these measures. Furthermore, maintaining heightened vigilance over the development of sector- specific NPLs and ensuring adequate provisioning levels[24] (Figure 27) are crucial for preserving the soundness of the banking sector.

Figure 32. Trend of E-wallets, and Bakong Wallets



Source: NBC; AMRO staff calculations

Figure 33. Property Price Index



Source: NBC

24. The financial supervisory framework and domestic financial safety net could be further strengthened. Moving forward, a macroprudential policy framework is necessary for more effective monitoring and mitigation of systemic risks. Specifically, to manage risks stemming from rapid credit growth in the real estate sector, the regulators should consider employing policy tools such as loan-to-value (LTV) and debt-to-income (DTI) ratios, in addition to imposing concentration caps on bank lending to the real estate sector. To bolster the resilience of domestic financial safety net, the introduction of a well-defined deposit protection scheme, supported by a solid legal framework and comprehensive regulations, is essential (see Annex 3 "Establishing a Deposit Insurance Scheme in Cambodia"), especially amid the rapid digitalization of financial services (Figure 30). In this regard, the establishment of the Deposit Protection Scheme Unit within the NBC is welcomed as a first step. Going forward,

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[24] The provision coverage ratio was elevated to 144.8 percent in Q4 2022 from 93.7 percent in Q1 2022, in tandem with the requirement of reclassification restructured loans. However, as the NPL ratio increased in H1 2023, the provision coverage ratio may have declined.

the features for the scheme should be carefully set, especially with regard to the amount of coverage for both local and foreign currencies, respectively, to strike a balance between promoting local currency usage and providing depositor protection in the highly dollarized economy. Moreover, as deposit protection is intended to minimize the risk of bank runs in the banking system, effective collaboration among all stakeholders in the financial sector is essential.

25. Tightening the regulatory oversight and supervision of the unregulated shadow banking activities is critical to mitigate the risks stemming from a prolonged real estate downturn. AMRO welcomes the timely policy measures taken by the government in April 2023 to support the real estate developers. These measures, especially tax exemptions have helped to relieve financing pressure on developers, while regulations such as Sub-Decree 50[25] have enhanced the management of real estate business. Nevertheless, the support measures can only provide temporary relief for developers, as the legal framework has not been completed yet. A more stringent oversight framework is required. First, regulators should maintain a comprehensive and consistent approach when it comes to evaluating, granting, and managing licenses to real estate developers. Second, adopting stringent regulations and vigilant monitoring are imperative to rein in lax lending practices between home buyers and developers. This is necessary to prevent the excessive expansion of credit in the shadow banking sector and minimize potential spillovers into the banking sector. Third, establishing a centralized and standardized data management system and expanding the coverage of the property price index (Figure 31) are essential in facilitating comprehensive analyses and effective surveillance. In this regard, the recent initiative taken by the government to improve the real estate market data sharing among stakeholders, is an important step forward. Fourth, concerted and effective coordination across regulatory bodies, particularly the NBC, Ministry of Economy and Finance, the Non-Bank Financial Services Authority, and the Ministry of Land Management, Urban Planning and Construction, will be critical in ensuring the successful implementation of these policy measures.

C.3 Strengthening Structural Reforms

26. Under the new government, a steadfast commitment to structural reforms remains crucial to sustain the momentum of economic growth. In the context of industrial development, diversifying the economic structure, particularly in the manufacturing sector, is essential to enhance Cambodia's resilience against external shocks and boost its global value chain participation. The tourism sector should accelerate the diversification of its products, targeting new tourist markets, and refining promotional themes (see Annex 4 "Structural Challenges in the Tourism Sector: The Case of Cambodia"). Meanwhile, on the production front, enhancing the skill sets of the current workforce is imperative. Simultaneously, addressing the ongoing challenge of high logistics costs is essential to overcome a significant bottleneck that hinders the competitiveness of Cambodia's economy. In the context of financial development, enhancing SME financing can be attained through the introduction of digital lending options, non-collateralized loans, and the provision of non-financial services. To enable effective strategic planning and achieve the development goals, the new government's key policy roadmap, including the Pentagonal Strategy (see Box B "Cambodia's Renewed Socio-economic Policy Initiative: Pentagonal Strategy"), should serve as a fundamental step in building social consensus and implementing structural reforms. In this regard, the establishment of a comprehensive national statistics system, encompassing GDP statistics,

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[25] The government issued Sub-Decree 50 on 2 March 2023, to determine the rules and procedures for managing and inspecting the real estate development business in Cambodia. The Sub-Decree is to ensure the effectiveness and transparency of management and control of the real estate development business and covers provisions on business operation, inspection, reporting, dispute resolution, and penalties for violation. A number of new and separate regulations are to be issued to implement provisions of this Sub-Decree.

industrial production, and labor market data, is essential in facilitating the analysis of the economy and formulation of timely policies.

Box B. Cambodia's Renewed Socio-economic Policy Initiative: Pentagonal Strategy[26]

Since the late 1990s, Cambodia has implemented its long-term socio-economic development policies—including the Triangular Strategy (1998-2003) and Four-Phase Rectangular Strategy (2003-2023) to facilitate the nation building after the end of the war. These strategies aimed at the restoration and reconstruction of the country, promoting peace and order within society, integrating the country into global and regional structures, fostering socio-economic stability, and enhancing the quality of life for citizens. Over the last 20 years, Cambodia experienced consistent and durable economic expansion, with an average annual growth rate of over 7 percent, due to its pursuit of prudent fiscal and monetary policies, and its high level of dollarization with no exchange control supported by a well-regulated financial system, which led to a surge in FDI inflows. The standard of living for millions of Cambodians has improved, with poverty reduction, education, and better welfare resulting in increased life expectancy. The economy has shifted from relying solely on traditional agriculture to a diverse and attractive base for high value-added industries. Recent achievements, such as its successful management of the COVID-19 pandemic and hosting of major international events, are evidence of Cambodia's progress.

In August 2023, Cambodia launched its Pentagonal Strategy as a renewed long-term socio-economic policy initiative to be implemented in five phases over the next 25 years to promote the country's growth, employment, equity, efficiency, and sustainability. After evaluating the progress made in the last 25 years, analyzing both regional and global trends, and predicting future outcomes for the next 25 years, the government set forth Cambodia Vision 2050[27] as a guide for all stakeholders to continue the momentum of peace and past achievements while building foundations for accelerated development in the medium and long term through targeted reforms in all areas. As the first five-year plan, the Pentagonal Strategy–Phase I, governing 2023-2028, the government will be focusing on growth, employment, equity, efficiency, and sustainability. This strategy builds upon previous successful strategies and aims to improve peace, stability, and public services while enhancing living standards and governance as it aims to achieve two main goals: 1) maintaining peace and promoting economic growth, as well as 2) laying the groundwork for Cambodia to become an upper middle-income country by 2030 and achieve its long-term vision for 2050. To achieve this, the strategy focuses on five sectors – i) public, ii) economic, iii) financial, iv) human and social capital, and v) environment and climate.

The Pentagonal Strategy includes: 1) the core of the strategy - institutional reforms and strengthening; 2) overarching environment conducive to the implementation of the entire strategy and 3) strategic pentagons to spur economic growth and social progress. More specifically, the Pentagonal Strategy–Phase I involves the integration of six crucial initiatives outlined by the Seventh Legislature of the National Assembly's Political Bureau.[28] These programs are set to be executed without delay by the end of 2023. To this end, the government has established mechanisms for coordinating, monitoring, and evaluating the implementation of the priority policy programs and key measures.

- **The core of the Pentagonal Strategy focuses on governance and institutional modernization of state institutions, making them modern, competent, strong, smart and clean**. This will enable the government to exercise political, economic, and administrative power

[26] Prepared by Vansopheaktraodorm Tep, Associate.
[27] Cambodia Vision 2050 aims to transform the country into a high-income nation with a skilled workforce, diversified economy, and sustainable environment. It focuses on five pillars: human capital development, economic diversification and competitiveness, environmental sustainability, good governance and institutional reform, and social inclusion and equity.
[28] The government's Six Priority Policy Programs for Immediate Implementation in 2023 includes: i) Expanding healthcare services towards the universal health coverage; ii) Providing nationwide vocational and technical training for youths from poor and at-risk households; iii) Institutionalizing the national social assistance program for poor households, vulnerable member of poor households, and at-risk households during economic crises and emergencies; iv) Enacting the Informal Economy Development Strategy to enable those in the informal economy to participate in the formal economy and seize the benefits from formal social protection system; v) Triggering coordination mechanisms and financing programs, aiming at promoting production, market access, and price stability for key agricultural products at reasonable prices; and vi) Deploying agricultural technical officers to all communes and Sangkats that have agricultural activities throughout the country, and establishing farmers' associations in rural areas.

to manage national affairs, with a strong emphasis on people-centric interests, nation-state building, and the rule of law (Table B1).

Table B1. Core of the Pentagonal Strategy: Governance Reform and Strengthening

	Core Priorities (5 Sides)	Strategic Objectives
1	Institutional reform and strengthening	Building a highly competent, strong, smart, and clean public administration to serve the best interest of people;
2	Improvements of human resources and work efficiency	Building competent and skilled human resources with a high sense of professionalism, ethical standards, and ownership, in accordance with roles and responsibilities
3	Enhancements in human resources and work efficiency	Promoting and strengthening cleanliness, integrity, and trust in public administration to contribute to efficient, inclusive, and sustainable socio-economic development;
4	Enhancement and strengthening if the effectiveness of laws and justice	Strengthening the rule of law, to further fight against social injustice, and to promote public trust in the justice sector
5	Strengthening of the governance of the private sector and businesses	Promoting all stakeholders' trust in the private sector and businesses by way of strengthening good governance of the private sector and businesses.

Source: National Assembly

- **The overarching objective is to establish a full and comprehensive framework to ensure the achievement of the policy priorities of the Pentagonal Strategy–Phase I.** By prioritizing security and political stability, implementing an open economic policy, promoting private sector participation, and strengthening partnerships, Cambodia has successfully improved its image and reputation both regionally and globally. This has enabled the country to mobilize financial, technical, and knowledge resources for socio-economic development, even amidst current geopolitical challenges and major global trends (Table B2).

- **The five strategic pentagons have been redesigned to address the needs and goals of Cambodia's new phase of development.** The government has established five main priorities for their Pentagonal Strategy-Phase I, which are people, road, water, electricity, and technology. By implementing interconnected measures in these five priority areas, the government aims to boost the economy's growth potential by enhancing overall economic productivity, labor productivity, and investment efficiency.

Table B2. Overarching Environment for Implementation of the Pentagonal Strategy

Five Priorities	Five Strategic Pentagons	Five Sides of the Pentagons
1. Continued strengthening of peace, political stability, security, and public order 2. Adherence to an independent, rule-based, and smart foreign policy 3. Ensuring macroeconomic and financial stability 4. Continued building of inclusive and effective partnerships for development cooperation, 5. Continued promotion of deeper regional and global integration	Pentagon 1: Human capital development	- Enhancement of the quality of education, sports, science, and technology, - Technical skills training - Improvements of people's health and well-being - Strengthening of the social protection system and food system - Strengthening of the quality of citizenship of a highly civilized society with morality, equity, and inclusiveness
	Pentagon 2: Economic diversification and competitiveness enhancement	- Development of key sectors and new sources of economic growth - Enhancement of connectivity and efficiency in transport and logistics, energy, water supply and digital sectors - Improvements in the business and investment environment - Strengthening of efficiency and attractiveness of special economic zones, including industrial parks, agro-industrial parks, and domestic free-trade zones - Innovation of financing mechanisms and financial products to support investment
	Pentagon 3: Development of the private sector and employment	- Development of the Labor market Promotion of micro, small, and medium enterprises (MSMEs), and startups - Entrepreneurship, and the development of the informal economy - Strengthening of public-private partnership - Promotion of competition, - Strengthening of the banking system and non-bank financial sector
	Pentagon 4: Resilient, sustainable and inclusive development	- Optimization of demographic dividends, strengthening of demographic resilience and promotion of gender equality - Sustainable management of natural resources, cultural heritages and tourism - Promotion of agriculture and rural development - Strengthening of urban management and modernization - Ensuring environmental sustainability and readiness for responding to climate change, as well as the promotion of a green economy
	Pentagon 5:	- Building digital government and digital citizens,

	Development of Digital Economy and Society	- Development of digital economy, digital business, e-commerce, and digital innovative system - Building and development of digital infrastructures - Trustworthiness building in digital system - Development of financial technology

Source: National Assembly

27. Cambodia's firm commitment to implementing comprehensive adaptation measures is vital to minimize physical risks of climate change, while addressing medium-term transition risks. The country's geographic and economic characteristics, its location in a low-lying coastal area with numerous rivers and its dependence on agricultural products, suggest that rising temperature would lead to severe weather changes that could undermine economic growth[29], likely leading to reduced productivity in agriculture, fisheries, and forestry. The frequency and severity of floods, droughts, and storms have escalated, resulting in substantial property damage, loss of life, and significant costs in rebuilding. In this context, effectively addressing the physical risks of climate change necessitates industry-specific and specialized infrastructure investments, as an initial step. This should be followed by a medium-term emphasis on facilitating the transition toward an environmentally friendly economic structure. Cambodia's updated Nationally Determined Contribution (NDC) includes a well-prepared set of action plans. Given the imperative for close coordination and the associated financial needs, the government should constantly evaluate the feasibility of the NDC. This is essential to ensure the effectiveness of the medium-term strategies aimed at bolstering sectors vulnerable to climate change.

28. The ongoing adoption of emerging technologies and the promotion of the digital economy will help enhance overall efficiency and productivity in Cambodia. The government is actively promoting digitalization to boost economic growth and enhance public services, with a focus on e-commerce, digital payments, healthcare, and education, including launching the "Cambodia Digital Economy and Society Policy Framework 2021-2035". With an increasing number of Cambodians gaining access to technology and digital services, the country is expected to experience significant benefits. Given that there remains a considerable journey ahead, the government's continued efforts are warranted to stimulate investments, support technology initiatives, and encourage more businesses to transition to digitalization.

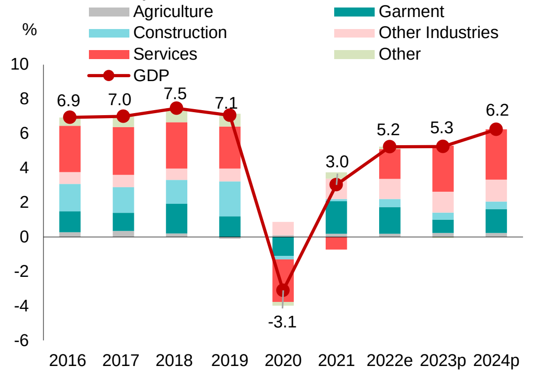
[29] Cambodia's susceptibility to global warming and climate change effects is evident as it is ranked 140th out of 181 countries, according to the 2020 Notre Dame Global Adaptation (ND-GAIN) Index.

Appendices

Appendix 1. Selected Figures for Major Economic Indicators

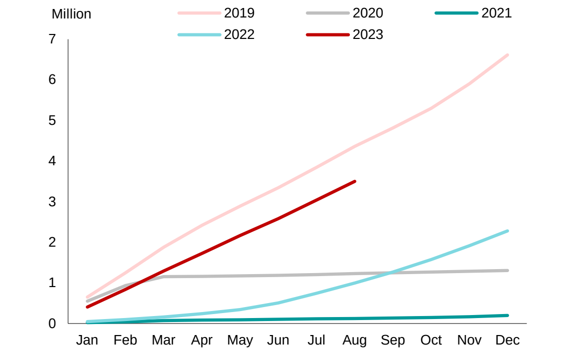
Figure 1.1. Real Sector

The economy gradually recovered in 2022 amid steady reopening and is expected to grow at a faster pace in 2023 and 2024.



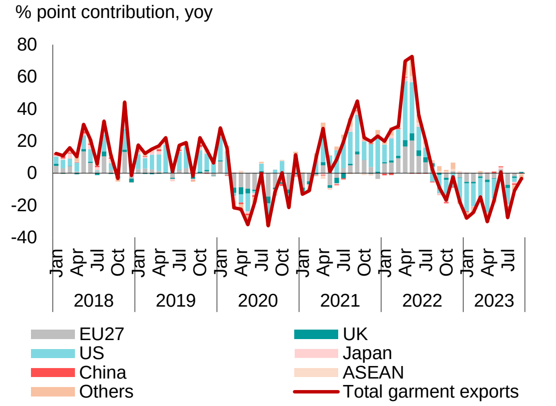
Source: National Institute of Statistics (NIS); AMRO staff calculations
Note: e = estimation; p = projection

The arrival of international tourists has accelerated with the reopening of borders, approaching 80 percent of the pre-pandemic levels.



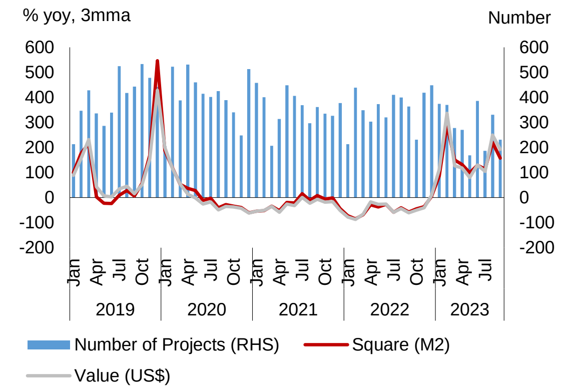
Source: Ministry of Tourism

Garment exports contracted from September 2022 and remain weak due to a slowdown in demand mainly from the US.



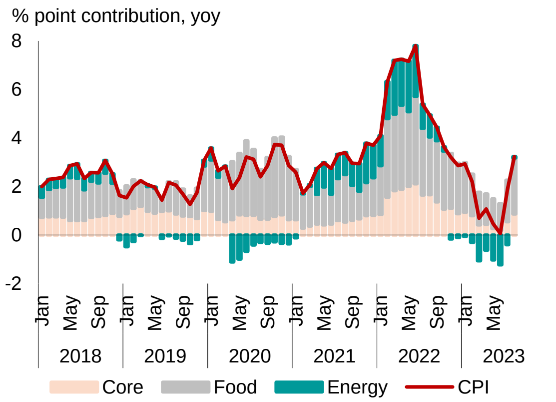
Source: General Department of Customs and Excise (GDCE)

The number of approved construction projects in first eight months of 2023 are smaller than in 2022, though squares and values increased.



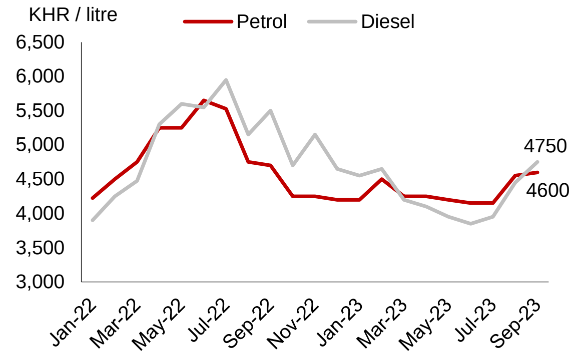
Source: Ministry of Land Management, Urban Planning and Construction

Headline inflation eased to 0.1 percent in June 2023, driven by lower energy and food prices, then surged to 3.2 percent in August due to the base effect.



Source: NIS; AMRO staff estimation

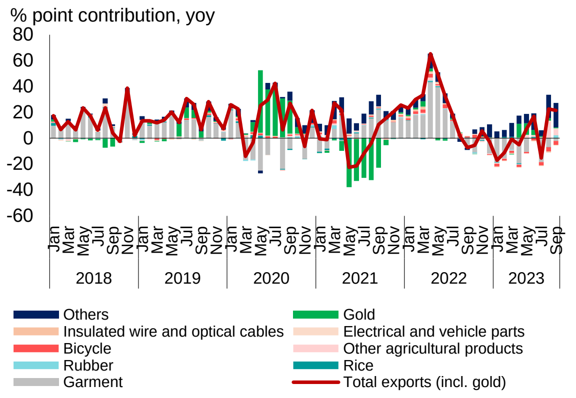
After sharply declining from the peak in May 2022, retail petroleum prices continued to stabilize in 2023 before slightly picking up from August.



Source: NIS

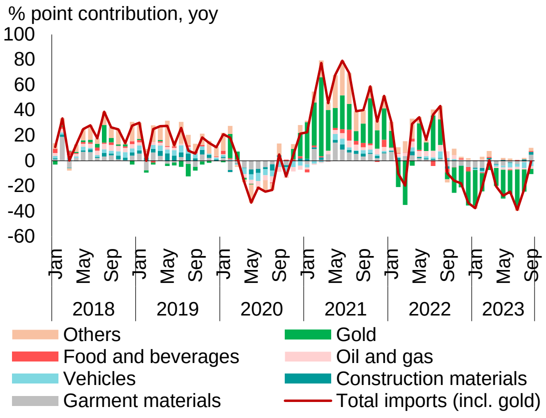
Figure 1.2. External Sector

Export growth contracted in January to April 2023 due to weak garment exports, then improving after May, largely driven by E&E and gold exports.



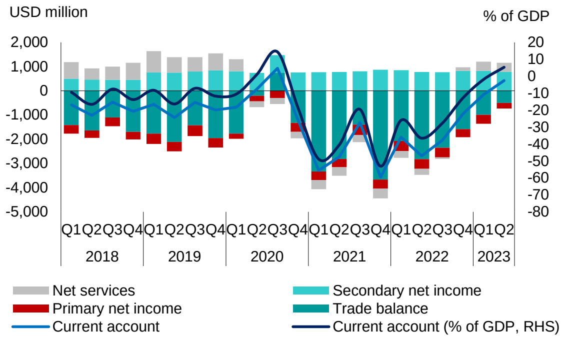
Source: GDCE, AMRO staff calculations

Imports have largely contracted since September 2022, mainly driven by a sharp reduction in gold imports.



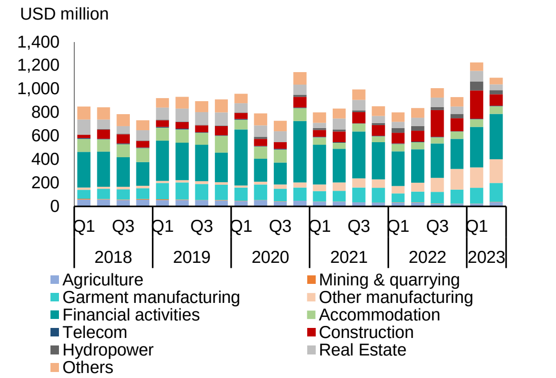
Source: GDCE, AMRO staff calculations

The current account registered a surplus of 5.3 percent of GDP in Q2 2023, mainly driven by improving trade balance of goods and services.



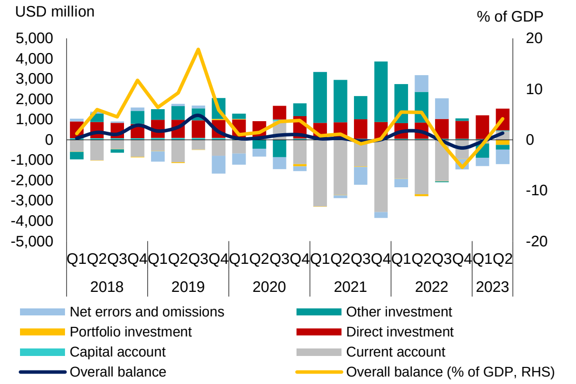
Source: GDCE, AMRO staff estimates
Note: Quarterly GDP figures are based on AMRO staff estimates.

FDI inflows surged to USD2.3 billion in H1 2023, mainly reflecting the inflows to construction, financial activities, and other manufacturing.



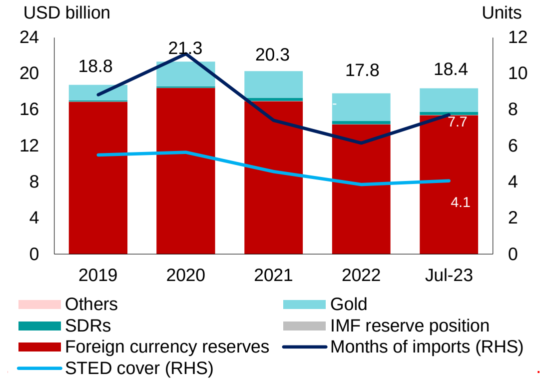
Source: NBC

Overall BOP registered a surplus of USD253 million in H1 2023, mainly driven by a surplus of the current account.



Source: NBC, AMRO staff calculations

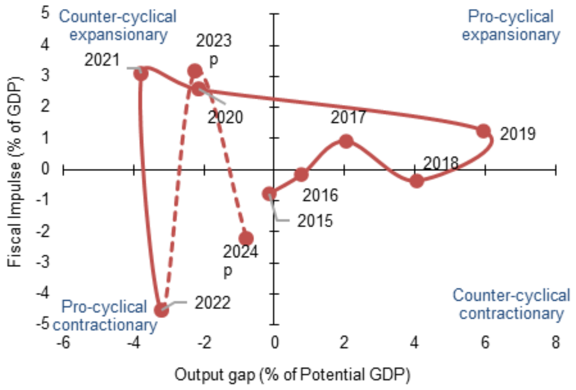
Cambodia's gross international reserves slightly increased to USD18.4 billion as of July 2023, equivalent to 7.7 months of imports.



Source: NBC, AMRO staff calculations

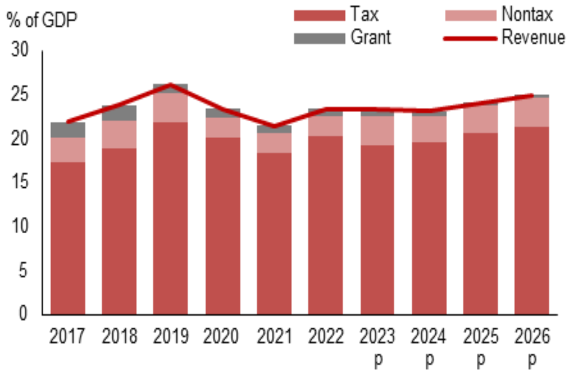
Figure 1.3. Fiscal Sector

Fiscal policy is set to be expansionary in 2023 with sustained spending before turning contractionary in 2024 with the fiscal consolidation plan.



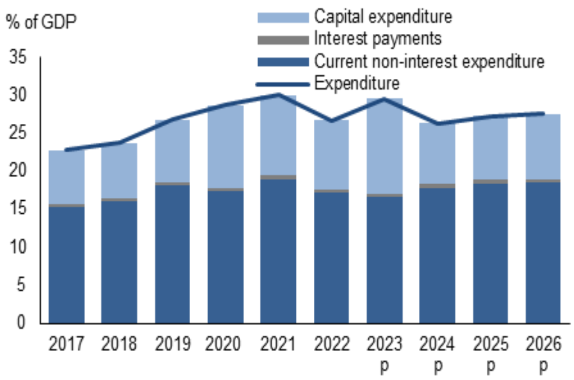
Source: Ministry of Economy and Finance (MEF); AMRO staff projections

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



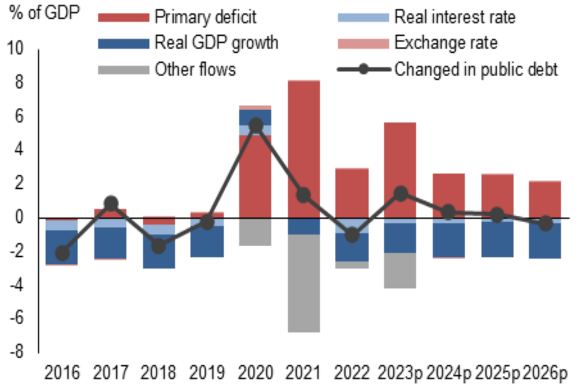
Source: MEF; AMRO staff projections

Fiscal consolidation efforts are projected to bring down expenditure over the medium term.



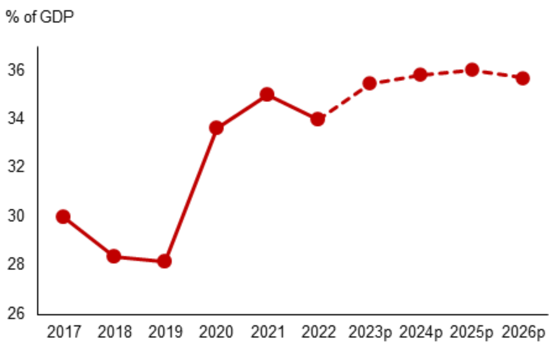
Source: MEF; AMRO staff projections

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



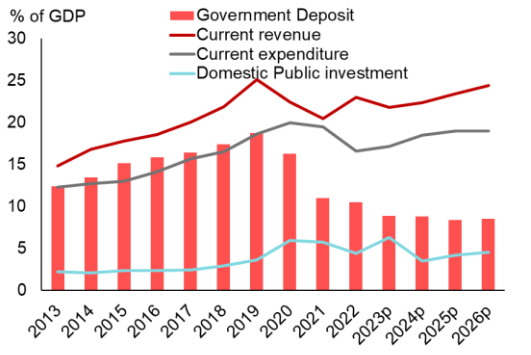
Source: MEF; AMRO staff projections

Public debt is expected to remain low, rising slightly over the next two years before slightly decreasing in 2026.



Source: MEF; AMRO staff projections

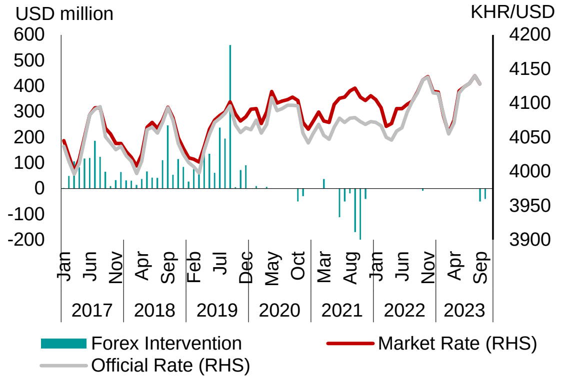
Fiscal reserves have declined sharply during the pandemic, but are expected to stay at lowered levels in the medium term.



Source: MEF; AMRO staff projections

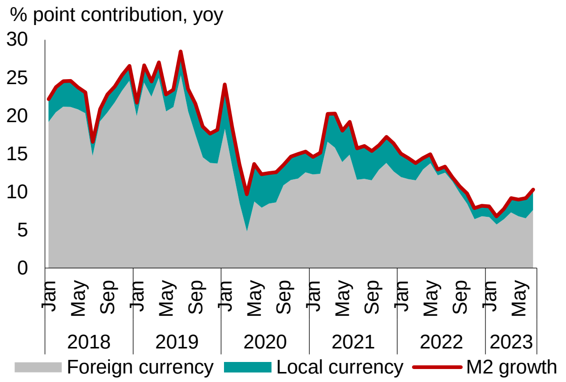
Figure 1.4. Monetary and Financial Sector

The riel depreciated against the US dollar amid the greenback's global strength, which led to the NBC's FX interventions in September and October 2023.



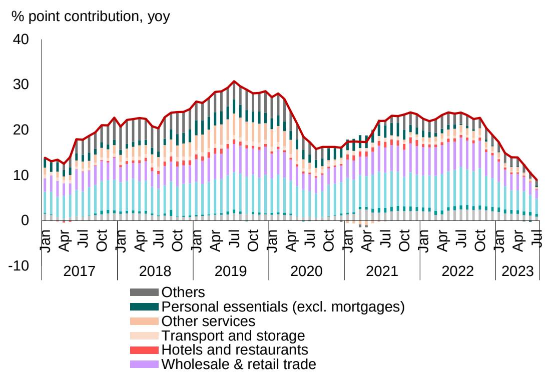
Source: NBC

Broad money (M2) growth has seen a slowdown since the beginning of 2022, and started to pick up since Q2 2023.



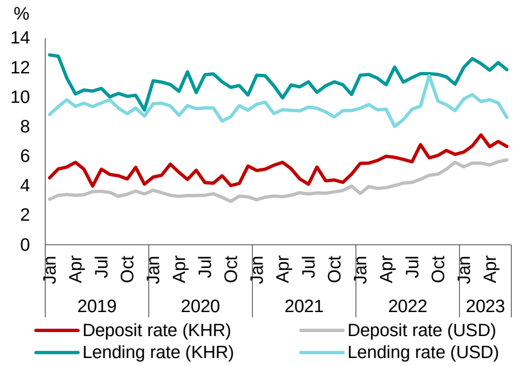
Source: NBC

Credit growth slowed down to 9.1 percent in July 2023, led by slower lending to the construction-related sector, domestic trade, and households.



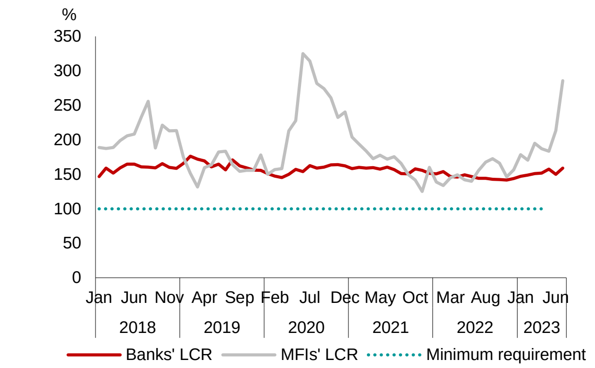
Source: NBC

Bank's deposit and lending rates for USD and KHR have exhibited a slight upward trend since H2 2022.



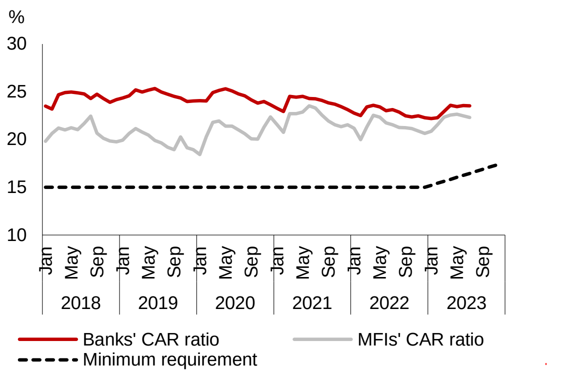
Source: NBC
Note: Based on the weighted average rates on term loans and deposits.

The liquidity coverage ratio for banks and deposit-taking MFIs stood well above the 100 percent minimum threshold.



Source: NBC

Banks and MFIs' capital buffers remained well above the minimum regulatory requirement.



Source: NBC

Appendix 2. Selected Economic Indicators for Cambodia

	2019	2020	2021	2022e	Projections 2023	Projections 2024
Real Sector and Prices	(In percent change, unless otherwise specified)					
Real GDP growth	7.1	-3.1	3.0	5.2	5.3	6.2
Agriculture	-0.5	0.6	1.1	1.1	1.5	1.5
Industry	11.3	-1.4	8.6	8.1	5.9	7.6
Services	6.2	-6.3	-1.9	4.8	7.4	8.3
GDP deflator	3.2	-0.7	1.3	4.1	2.4	2.5
CPI inflation (average)	1.9	2.9	2.9	5.3	2.6	3.1
Core inflation (average)	2.7	2.1	1.6	4.4	2.4	2.6
CPI inflation (end of period)	3.1	2.9	3.7	2.9	5.0	1.4
External Sector	(In USD millions, unless otherwise specified)					
Current account balance	-2,930.6	-881.2	-10,892.9	-7,581.5	-834.0	-1,748.7
(Including gold, in percent of GDP)	-10.8	-3.4	-40.4	-25.7	-2.6	-5.1
Trade balance	-7,255.5	-2,543.8	-11,205.3	-8,825.7	-2,462.2	-3,198.4
Exports	14,986.1	18,522.2	19,520.9	23,179.5	23,921.5	25,947.1
Imports	22,241.6	21,066.0	30,726.2	32,005.2	26,383.7	29,145.5
Services, net	2,812.3	-257.2	-1,432.4	-435.7	514.6	555.7
Primary income, net	-1,640.9	-1,108.9	-1,489.5	-1,551.0	-1,645.0	-1,726.4
Secondary income, net	3,153.4	3,028.7	3,234.3	3,230.9	2,758.6	2,620.4
Financial account balance	6,726.4	3,275.2	12,260.6	7,016.6	2,131.2	4,243.2
(In percent of GDP)	23.5	11.7	44.7	23.1	5.9	11.5
Foreign direct investment, net	3,561.2	3,497.6	3,391.0	3,428.3	3,481.2	3,681.2
Portfolio investment, net	-12.5	-96.0	-51.2	-126.1	-130.2	-78.6
Other investment, net	2,821.5	-385.5	8,716.6	3,505.1	-1,493.4	367.1
Overall balance	2,668.7	636.6	82.4	346.5	590.0	1,104.6
(In percent of GDP)	9.9	2.5	0.3	1.2	1.9	3.2
Gross international reserves	18,762.0	21,334.0	20,266.0	17,805.2	18,395.2	19,499.9
(In months of imports)	8.8	11.1	7.4	6.1	7.6	7.3
(In months of imports, excluding gold)	8.9	11.5	9.0	7.1	7.7	7.3
External debt	15,377.4	17,610.8	20,063.2	22,212.4	23,914.0	26,309.5
(In percent of GDP)	56.9	67.8	73.8	75.0	75.8	76.6
Fiscal Sector	(In percent of GDP)					
Revenue and grants	26.2	23.4	21.2	23.5	23.1	23.2
Tax revenue	22.0	20.1	18.3	20.3	18.9	19.7
Non-tax revenue	3.3	2.4	2.2	2.3	3.4	3.0
Grants	1.0	1.0	0.9	0.8	0.8	0.5
Expenditure	26.9	28.8	29.9	26.8	29.3	26.5
Current non-interest expenditure	18.3	17.4	19.1	17.2	16.7	18.0
Interest payments	0.4	0.5	0.5	0.4	0.5	0.6
Capital expenditure	8.2	10.9	10.3	9.2	12.0	7.9
Overall fiscal balance	-0.6	-5.3	-8.5	-3.3	-6.2	-3.2
Primary balance	-0.2	-4.9	-8.0	-2.9	-5.7	-2.7
Public debt	28.1	33.8	35.0	34.0	35.4	35.6
Monetary and Financial Sector	(In percentage change, end-period)					
Domestic credit	24.4	20.0	32.5	19.2	13.6	19.0
Government	47.3	4.6	-21.8	12.2	28.1	25.7
Private sector	28.0	17.2	23.6	18.5	15.0	19.8
Broad money	18.2	15.3	16.4	8.2	11.0	15.9
Reserve money	34.5	-2.1	10.2	-4.8	2.7	4.3
Loan-to-deposit ratio (average, in percent)	95.1	101.3	105.9	115.5	117.1	121.3
Non-performing loan ratio (average, in percent)	2.4	2.5	2.4	2.9	4.8	4.5
Memorandum Items						
Nominal GDP (KHR billion)	110,014.0	105,891.8	110,505.9	121,029.9	130,420.9	142,043.8
Nominal GDP (USD million)	27,089.4	25,872.8	26,961.1	29,504.8	31,540.7	34,497.6
GDP per capita (USD)	1,693.8	1,544.4	1,585.0	1,715.4	1,812.7	1,874.9
Exchange rate (KHR/USD, average)	4,061.1	4,092.8	4,098.7	4,102.0	4,135.0	4,117.5
Exchange rate (KHR/USD, end of period)	4,084.0	4,076.5	4,113.5	4,118.0	4,110.0	4,100.0

Source: National authorities; AMRO staff estimates and projections

Appendix 3. Balance of Payments

	2016	2017	2018	2019	2020	2021	2022e
	(In USD millions, unless otherwise specified)						
Current account	**-1,734**	**-1,807**	**-2,897**	**-2,931**	**-881**	**-10,893**	**-7,581**
Trade balance	-3,846	-4,278	-5,844	-7,255	-2,544	-11,205	-8,826
Exports, f.o.b.	10,273	11,224	12,963	14,986	18,522	19,521	23,179
of which, garment exports, f.o.b.	7,449	8,020	9,507	10,792	9,871	11,390	12,990
Imports, f.o.b.	14,119	15,502	18,806	22,242	21,066	30,726	32,005
Services, net	1,602	1,863	2,395	2,812	-257	-1,432	-436
Receipts	4,033	4,608	5,451	6,086	1,767	657	2,318
Payments	2,430	2,745	3,056	3,274	2,025	2,090	2,754
Primary income, net	-1,050	-1,141	-1,329	-1,641	-1,109	-1,490	-1,551
Receipts	377	442	580	655	610	331	346
Payments	1,427	1,582	1,908	2,296	1,718	1,820	1,897
Secondary income, net	1,561	1,748	1,881	3,153	3,029	3,234	3,231
of which: official tranfer	506	550	579	532	449	510	479
Others	1,055	1,199	1,302	2,622	2,580	2,724	2,752
Capital and financial account	**2,902**	**3,671**	**3,886**	**6,726**	**3,275**	**12,261**	**7,017**
Capital account	283	279	326	355	259	204	209
Financial account (net)	2,619	3,393	3,561	6,371	3,016	12,056	6,807
Direct investment	2,397	2,673	3,089	3,561	3,498	3,391	3,428
Other investment	224	725	513	2,821	-385	8,717	3,505
Errors and omissions	-296	-233	455	-1,127	-1,757	-1,285	911
Overall balance	873	1,631	1,445	2,669	637	82	347
Memorandum items:							
Exports of goods and services	14,306	15,832	18,414	21,072	20,290	20,178	25,497
Imports of goods and services	16,550	18,247	21,863	25,516	23,091	32,816	34,759
Trade account (percent of GDP)	-19.2	-19.3	-23.8	-26.8	-9.8	-41.6	-29.9
Current account (percent of GDP)	-8.7	-8.1	-11.8	-10.8	-3.4	-40.4	-25.7
Capital and financial account (percent of GDP)	14.5	16.6	15.8	24.8	12.7	45.5	23.8
Overall Balance (percent of GDP)	4.4	7.4	5.9	9.9	2.5	0.3	1.2
International reserves (USD million)	9,123	12,200	14,630	18,762	21,334	20,266	17,805
In months of imports of goods and services	6.6	8.0	8.0	8.8	11.1	7.4	6.1
Nominal GDP (USD million)	20,017	22,177	24,572	27,089	25,873	26,961	29,505

Source: National authorities; AMRO staff estimates

Appendix 4. Statement of General Government Operations

	2018	2019	2020	2021	2022	2023BL
	(In percent of GDP)					
Total Revenue and Grants	23.8	26.2	23.4	21.6	23.6	23.2
Total Domestic Revenue	22.1	25.3	22.5	20.7	22.7	22.5
Central Govt	20.4	23.2	20.4	18.6	20.6	20.5
Local Govt	1.6	2.0	2.1	2.1	2.1	2.0
Current Revenue	21.9	25.1	22.3	20.6	22.6	21.6
Total Tax Revenue	19.0	22.0	20.1	18.4	20.3	19.6
Tax Revenue Central	17.4	20.0	18.3	16.7	18.7	18.0
Domestic Taxes	15.0	17.4	16.2	14.8	16.5	16.0
Direct Taxes	4.1	4.6	5.5	5.4	6.1	5.6
Indirect Taxes	10.9	12.8	10.7	9.4	10.5	10.4
VAT	5.8	7.4	6.2	5.4	6.0	6.1
Excise	5.2	5.4	4.5	4.0	4.4	4.3
Trade Taxes	2.4	2.6	2.1	1.9	2.1	1.9
Tax Revenue Local	1.6	1.9	1.8	1.6	1.6	1.7
Non-tax revenue Central	2.9	3.0	2.0	1.8	1.9	1.6
Non-tax revenue Local	0.0	0.1	0.2	0.5	0.5	0.3
Capital Revenue	0.2	0.2	0.2	0.1	0.1	0.9
Grants	1.8	1.0	1.0	0.9	0.8	0.8
Total Expenditure	23.8	26.9	28.8	30.1	26.8	29.5
Current Expenditures	16.5	18.7	17.9	19.5	17.6	18.5
Wages and Salaries	8.0	7.4	8.1	7.7	7.3	7.3
Non-wages	6.7	8.9	7.9	9.6	7.5	8.4
Interest Payment	0.4	0.4	0.5	0.5	0.4	0.5
Domestic	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	0.3	0.4	0.5	0.5	0.4	0.5
Capital Expenditures	7.3	8.2	10.9	10.6	9.2	11.1
Domestic Financed	3.0	3.6	6.0	5.8	4.4	6.3
Foreign Financed	4.3	4.6	4.9	4.8	4.7	4.7
Current Balance (excl. grant)	5.4	6.4	4.4	1.1	5.0	3.1
Primary Balance (excl. grant)	-1.3	-1.2	-5.9	-9.0	-3.6	-6.5
Fiscal Balance (incl. grant)	0.0	-0.6	-5.3	-8.5	-3.2	-6.3
Fiscal Balance (excl. grant)	-1.7	-1.6	-6.3	-9.4	-4.0	-7.0

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

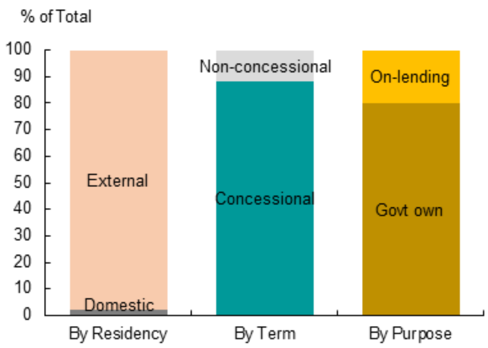
Appendix 5. Debt Sustainability Analysis[30]

Background

1. Cambodia's public debt increased during the pandemic due to broad fiscal support measures to protect vulnerable households and support economic recovery. Prior to the pandemic, the public debt-to-GDP ratio stood at 28.1 percent in 2019. This steadily rose to 33.7 and 35.0 percent of GDP in 2020 and 2021, respectively, as government rolled out various support measures to mitigate the impact of the COVID-19 pandemic.[31] In 2022, the public debt-to-GDP ratio fell to 34.0 percent on strong revenue collection and lower health expenditure as the pandemic came under control. Gross financing needs (GFN) also rose during the pandemic, peaking at 9.6 percent of GDP in 2021, mainly driven by the expansion of the primary deficit. GFN has gone down to 4.5 percent of GDP in 2022, as higher revenue and lower pandemic related spending narrowed the primary deficit. Meanwhile, interest and amortization payments of Cambodia remain stable.

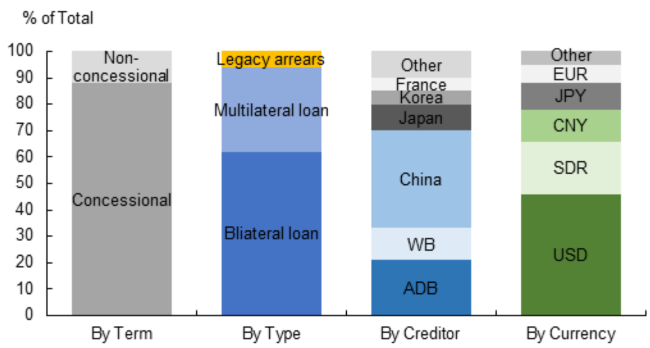
2. Public debt comprises predominantly external loans which are highly concessional. As of end-2022, external debt accounted for 99 percent of total public debt. For the first time in 2022, the government issued local-currency bonds, however, the government bond market remains nascent. The bulk of the debt are on highly concessional terms, with a weighted average maturity of 26.9 years, grace period of 8.4 years and average interest rate of 1.1 percent. Around 20 percent of government debt is on-lent to SOEs, with the Electricity of Cambodia and Phnom Penh Water Supply Authority being the major recipients, accounting for 74 percent and 11 percent, respectively. On public external debt, 62 percent are in the form of bilateral loans, and 6 percent are designated as legacy arrears to Russia and the United States. The largest bilateral donor is China, accounting for 37 percent of the total. Meanwhile, 46 percent of public external debt is denominated in USD.

Figure 5.1. Public Debt Structure



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

Figure 5.2. Public External Debt Structure



Source: MEF; AMRO staff estimates

Baseline Debt and GFN Projections

3. Public debt is projected to rise modestly and peak in 2025 based on steady fiscal consolidation and improving growth prospects. Economic growth is projected to remain subdued compared to pre-pandemic levels as the tourism and real estate sectors, which were the primary engines of the Cambodian economy before the pandemic, are still regaining

[30] Prepared by Paolo Hernando, Senior Economist
[31] Government provided support to both households and firms. Key fiscal support measures for households include cash transfer to the poor, wage subsidies and cash for work scheme, which helped support households through the pandemic. 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.

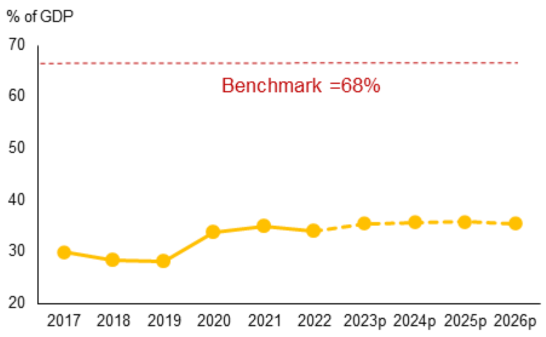
strength. The effective interest rate is expected to remain low, reflecting continuing access to highly concessional loans. The fiscal deficit is expected to decline, in line with the authorities' medium term consolidation plan, however, revenue is projected to remain below pre-pandemic level. The combination of fiscal consolidation and enhanced growth prospects is expected to gradually slow the pace of the debt increase, with the debt-to-GDP ratio stabilizing at 35.8 percent in 2025 and then fall to 35.5 percent in 2026 (Table 5.1 and Figure 5.5). With the public debt projected to increase only moderately over the medium-term, it remains well below the threshold for Cambodia (Figure 5.3).[32] Meanwhile, with smooth amortization and interest payments throughout Cambodia's debt maturity profile, GFN is mainly driven by changes in the primary deficit (Figure 5.6). The GFN is expected to rise to 7.5 percent of GDP in 2023 from 4.5 percent in 2022 due to additional stimulus measures, however, it is projected to steadily decline from 2024 in line with the fiscal consolidation plan (Figure 5.4).

Table 5.1. Macroeconomic and Fiscal Indicators

	2018	2019	2020	2021	2022	2023p	2024p	2025p	2026p
Macroeconomic indicators (Percent)									
Real GDP growth	7.5	7.1	-3.1	3.0	5.2	5.3	6.2	6.3	6.4
GDP deflator	3.1	3.2	-0.7	1.3	4.1	2.4	2.5	2.3	2.3
Effective interest rate	1.4	1.6	1.6	1.4	1.3	1.6	1.8	1.8	1.4
Fiscal indicators (Percent of GDP)									
Revenue	23.8	26.2	23.4	21.5	23.5	23.1	23.2	24.3	25.1
Expenditure	23.8	26.9	28.8	30.1	26.8	29.3	26.5	27.4	27.7
Fiscal balance	0.0	-0.6	-5.3	-8.6	-3.3	-6.2	-3.2	-3.1	-2.6
Primary balance	0.4	-0.2	-4.9	-8.1	-2.9	-5.7	-2.7	-2.6	-2.1
Public debt	28.4	28.1	33.7	35.0	34.0	35.5	35.7	35.8	35.5
Gross financing needs	2.5	2.4	6.4	9.6	4.5	7.5	4.4	4.3	3.6

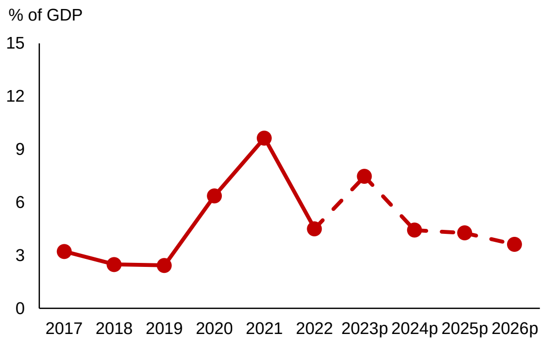
Source: MEF; National Institute of Statistics (NIS); AMRO staff estimates
Note: The macroeconomic and fiscal indicators for 2023-2026 are based on AMRO staff estimates and projections.

Figure 5.3. Public Debt



Sources: MEF; AMRO staff estimates

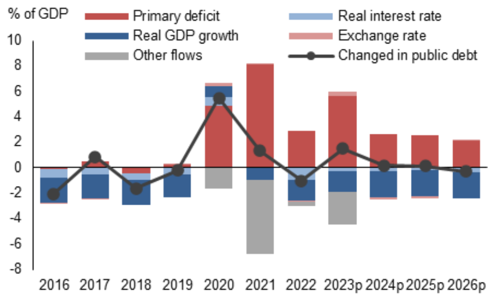
Figure 5.4. Gross Financing Needs



Sources: MEF; AMRO staff estimates

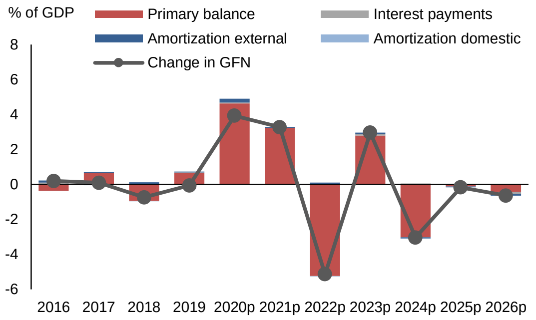
[32] Cambodia has a medium debt carrying capacity according to the Composite Indicator (CI) developed by the IMF and World Bank, with an indicative threshold of 55 percent for the present value (PV) of debt-to-GDP ratio. This has been adjusted to nominal terms equivalent to 68 percent of debt-to-GDP ratio for intuitive comparison with the nominal debt projections.

Figure 5.5. Public Debt Dynamics



Sources: MEF; AMRO staff estimates

Figure 5.6. Changes in Gross Financing Needs

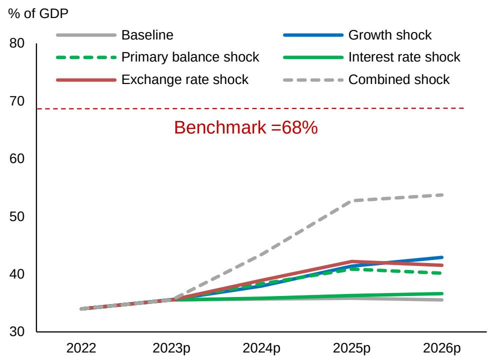


Sources: MEF; AMRO staff estimates

Macro-Fiscal Risks – Stress Tests

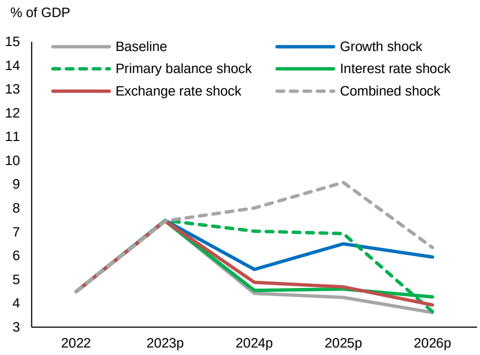
4. Cambodia's public debt ratio remains well below the threshold when subject to simulated shocks.[33] Cambodia's prudent fiscal policy, characterized by its minimal initial debt burden and medium-term fiscal consolidation plan, acts as a robust buffer against adverse economic developments, ensuring that the debt-to-GDP ratio remains well within the threshold against all the simulated shocks (Figure 5.7). Stress test results indicate that Cambodia's debt dynamics are sensitive to growth shock, exchange rate shock and primary balance shocks. Meanwhile, gross financing needs are sensitive to shocks to the primary balance, peaking at 9.1 percent of GDP in 2025 under the combined shock. Under such extreme circumstances, the fiscal reserves which stood at around 11 percent of GDP as of end-2022 would be sufficient to cover gross financing needs.

Figure 5.7. Public Debt Stress Test



Source: MEF; AMRO staff estimates

Figure 5.8. GFN Stress Test



Source: MEF; AMRO staff estimates

Overall Assessment

5. Cambodia is assessed to be at low level of public debt sustainability risk. The public debt-to-GDP ratio remained well below the threshold in the baseline and all stress test scenarios over the projection period. Fiscal buffers are also seen as adequate to cover gross financing needs even for the case of the most extreme shock. With the bulk of public debt at highly concessional terms, and smooth maturity profile over the debt redemption period, Cambodia's public debt sustainability analysis (DSA) results show the overall risk of public debt sustainability to be low.

[33] The scenarios for the stress tests are as follows: 1) Real GDP growth shock: one standard deviation or –3.3 percentage points shock to 2024 and 2025; 2) Primary balance shock: one standard deviation or –2.7 percent of GDP shock to 2024 and 2025; 3) Interest rate shock: +2 percentage points shock from 2024; 4) Exchange rate shock: +5 percentage points depreciation shock in 2023 and 2024; 4) Combined shock: all of the above.

Appendix 6. 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	- BOP data is released on a quarterly and yearly basis with a time lag of one to two 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 two 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, and monetary and credit data, 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.

Appendix 7. Climate Clipboard—Risks, Responses, and Opportunities[34]

A. Physical risks

Exposure/ Sources of risk	Potential macro-financial impact
• Floods (chronic) • Drought (chronic) • Sea-level rise (chronic)	• Most of Cambodia's agricultural areas will be exposed to higher risks of drought than in the past. Over the past 20 years, losses in production were mainly due to flooding (about 62%) and drought (about 36%). Most flooding occurs due to increased water levels in the Mekong River and Tonle Sap Lake between early July and early October. Disruptions to logistical corridors caused by floods have a profound impact to agricultural supply chains, both domestically and for international trade • More than 4 million hectares of lowland forest, especially those located in the northeast and southwest, which currently have a water deficit period of between four and six months, will become exposed to a water deficit period of between six and eight months or more • Analysis of the impact of sea-level rises along coastal areas suggests that a total area of about 25,000 ha would be permanently inundated by a sea level rise of one meter, increasing to 38,000 ha with a sea level rise of two meters

B. Transition risks

Sources of risk	Potential macro-financial impact
• Increase the use of renewable energy and large-scale displacement of coal in industries • Risk of difficulties in financing to respond to climate change • Apply energy efficient technologies	• Expanding use of relatively expensive renewable energy could have an impact on inflation and GDP growth • Insufficient concessional loans or international aid may cause setbacks in climate change implementation plans and place a burden on the government budget • As imports increase in the process of introducing environmentally friendly equipment, the current account may worsen. Separately, it may take time to train personnel to utilize new equipment

C. Adaptation response framework and strategies

Adaptation framework	Key initiatives/ strategies	Estimated financing need and sources	
National Adaptation Plan(Oct 2021)	• The implementation of climate change adaptation in Cambodia focuses on the following areas: i) Food, Water, and Energy security; ii) Reduce sectoral, regional, gender vulnerability and Health risks; iii) Resilience of critical Ecosystems; iv) Low-carbon planning and technologies; v) Improve Capacities; vi) Promote Adaptive Social Protection; vii) Strengthen coordination frameworks; and viii) Strengthen collaboration on regional and global processes	• USD0.4 billion between 2020 and 2059 under a very high GHG emissions scenario • USD2 billion through 2030 based on the updated NDC	
		Domestic	**External**
		Annual budgets	-

D. Mitigation response framework and strategies

Nationally Determined Contribution (NDC)	National framework/ Strategies	Estimated financing and sources
• Reduce GHG emissions by 41.7 percent in 2030 relative to Business As Usual emissions by 2030 (Dec 2020) • Of the above 41.7% reduction, approximately 60% is planned to be achieved in the Forestry and other Land Use sector • The above GHG includes carbon dioxide (CO2), methane (CH4), and nitrous oxide (N2O) **Long-term commitment** • [Long Term Strategy for Carbon Neutrality](#) (Dec 2021)	• NDC Roadmap ➢ Roadmap maps out the pathway to the NCD in 2030 • Long-term Strategy for Carbon Neutrality ➢ Achieve carbon neutrality by further reducing carbon emissions compared to Business as Usual by 2050 (Sources of GHG emissions table and key sectoral strategies below)	• USD5.8 billion in investments by 2030. Of that investment, Forestry (USD3.47 billion), Waste (USD 1.49 billion), Energy (USD672 million), Industry (USD79 million), Agriculture (USD50 million), and Transport (USD11 million) • The Department of Climate Change will prepare a climate investment plan by 2025 • Public financing needs reach to USD90 billion by 2050 (LTS4CN)

Sources of GHG emissions (Unit: Million t-CO2)

Sector	NDC 2030	BAU 2030
FOLU (Forestry and other Land Use)	38.2	76.3
Energy	20.7	34.4
Agriculture	20.9	27.1
Industry	8.0	13.9
Waste	2.7	3.3
Total	**90.5**	**155.0**

Source: Cambodia's NDC (Dec 2020)

Key sectoral strategies and initiatives

- Agriculture
  - ➢ Less methane-intensive rice cultivars
  - ➢ Direct seeding practices
  - ➢ Promotion of organic fertilizer and deep fertilizer technology
  - ➢ Improved fodder management
  - ➢ Introduction of composting technology
- Forestry and other land uses
  - ➢ This is formulated as a long-term low GHG emission development strategy in accordance with the Paris Agreement.
  - ➢ Afforestation, improved forest management and forest restoration
  - ➢ Agroforestry and commercial tree plantation
- Energy
  - ➢ No new coal generation capacity beyond already committed projects
  - ➢ Increase in solar, hydro, biomass and other renewables to 35 percent of the generation mix by 2050, of which 12 percent is from solar
  - ➢ Investments in grid modernization, flexibility and storage Energy efficiency measures in buildings and industry
- Transportation

[34] Prepared by Jungsung Kim, Economist

	➢ More use of public transportation ➢ Moderate penetration of electric vehicles ➢ Increased fuel efficiency for internal combustion engine vehicles ➢ CNG penetration of 80 percent for interregional buses and 80 percent for trucks until 2050 • Industrial process and produce use ➢ Clinker substitution in cement production ➢ Carbon capture and storage for cement kilns ➢ Use of recycled aggregate concrete ➢ Increasing use of refrigerants with low global warming potential ➢ Regular inspection of refrigeration and air-conditioning equipment and recovery of spent refrigerant • Waste ➢ Reducing open burning by expanding waste collection coverage to 85 percent in 2050 ➢ Implementing a reduce, reuse, and recycle strategy ➢ Landfill gas management	

E. Enabling regulations for climate resilience		
E.1. Legal framework	**E.3. Carbon pricing frameworks**	**E.4. Sustainable finance frameworks**
• A General Secretariat (GSSD) was established to support the operations of the NCSD and for coordinating the development of policies, strategic plans, action plans, and legal instruments concerning sustainable development, including the green economy and climate change **E.2. GHG accounting framework** • There is no national-level GHG accounting framework as of September 2023	• Ministries are discussing to introduce emissions trading system (ETS) ➢ The Global Green Growth Institute (GGGI), together with the Ministry of Environment held an inter-ministerial workshop introducing key decisions to be taken as part of Cambodia's preparations for carbon trading under Article 6 of the Paris Agreement in 2022	• **Cambodian Sustainable Finance Principles Implementation Guidelines (Feb 2019)** ➢ The aim of basic guidelines is to serve as a basis for the Cambodian banks and microfinance institutions (MFIs) in developing their own sustainable finance approaches, in line with the Cambodian Sustainable Finance Principles ➢ The intention of the guidelines is to encourage banks to seriously consider the impact of climate change when conducting business ➢ This Principle also aims to build knowledge of sustainable finance within banks/ MFIs and across the banking sector, among banks/ MFI customers, and among the communities the banks/ MFIs serve

E.5. Financial system		
Initiatives	**Guidelines**	**Status**
1. Taxonomy	• No guidelines have been established yet	-
2. Risk management assessments	• Banks/ MFIs should seek to develop and implement an environmental risk management system (February 2019, The Association of Banks in Cambodia)	• Development of an environmental risk reporting framework and criteria (relevant key performance indicators (KPIs) to monitor and report on progress against the bank's/ MFI's environmental commitments) • Ensuring that the necessary systems are in place to collect the relevant data • Developing E&S policies (general E&S Policy and specific E&S policies, as applicable), approved by top management, that adequately address environmental issues • Establishing E&S governance structures, aligned with the existing operating model for the management of other risk categories – particularly credit risk, transaction approval and new client acceptance
3. Climate-related financial disclosures	• **Recommendations of the Task Force on Climate-related Financial Disclosures** (June 2017)	• The task force suggested core elements of Recommended Climate-Related Financial Disclosure including governance, strategy, risk management, and targets
4. Data availability	• No specific data set is available for the impact of climate change on the financial system.	-
5. Capacity building	• Various initiatives being led by National Council for Sustainable Development (GSSD)	• GSSD lead in coordination, integration, capacity building and knowledge management, stakeholder engagement and awareness, legal frameworks, NDC review.

F. Potential opportunities from the low-carbon transition		
• Investment in renewable energy • Improving energy productivity	• Job creation and wage increase • Promote climate-friendly agribusiness rice value chain and profit in rice production value chains	• Contributing to improved livelihoods as well as a stronger economy

Source: National authorities; media reports; AMRO staff

Annexes: Selected Issues

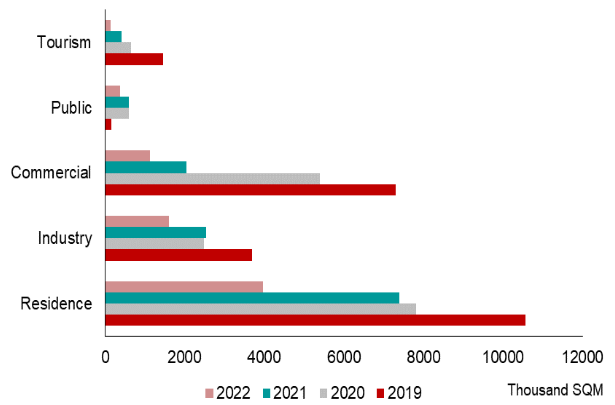
Annex 1. Navigating Double Challenges: Real Estate Downturn and Hidden Risks of Shadow Banking in Cambodia[35]

Cambodia's real estate market has seen significant growth over the past decade. However, the market has experienced a downturn since late 2022. A complex set of risks has been quietly accumulating under the surface, particularly risks of delayed completion and potential default of developers. The government has tried to support real estate developers. However, more stringent oversight is needed to control the risks. Additionally, the current legal framework should be enhanced to set a foundation for more stable development of the real estate sector in the future.

Cambodia's Real Estate Sector in a Downturn

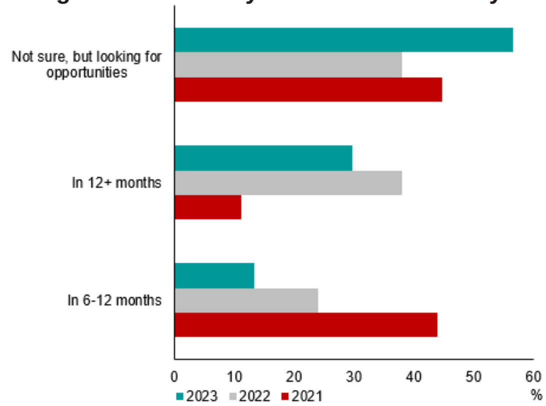
1. **The real estate market has experienced a slowdown in both supply and demand after a boom during 2019-2020**. According to the Ministry of Land Management, Urban Planning, and Construction (MLMUPC), total investment capital in real estate and construction projects decreased to USD 2.97 billion in 2022, compared to USD5.33 billion and USD7.75 billion in 2021 and 2020, respectively. All segments including residential, industrial, and commercial projects witnessed a decrease in the square meters (SQM) being constructed (Figure A1.1). The total SQM being constructed for residential projects decreased to 3.96 million SQM in 2022 compared to the peak of 10.58 million SQM in 2019. A survey indicated that the readiness to buy within the next 12 months also declined significantly (Figure A1.2). Furthermore, a reduction in foreign investments, especially from China, and a slower-than-anticipated recovery in the garment and tourism sectors, have resulted in a deterioration in local residents' incomes and their purchasing powers.

Figure A1.1. Construction by Segment



Source: Ministry of Land Management, Urban Planning, and Construction

Figure A1.2. Survey on Readiness to Buy



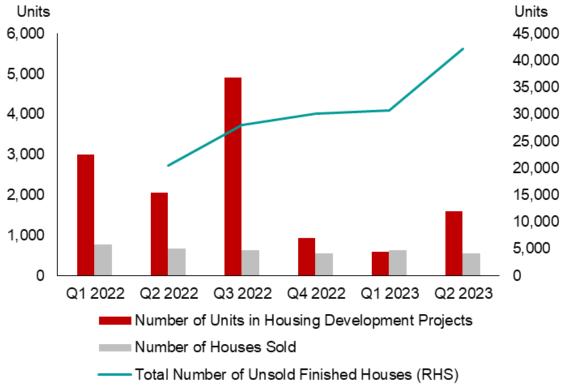
Source: Realestate.kh.com
Note: Realestate.kh.com has conducted annual surveys on Cambodia's real estate sector since 2017. Surveys cover over 2000 respondents, including both Cambodians and foreigners with various ages, professions, and income levels. The figure reflects readiness to buy in January each year.

2. **The real estate market faces the challenge of oversupply.** Oversupply has primarily stemmed from the construction boom during 2018-2019 when developers raced to meet the demand of foreign investors rather than that of domestic buyers. Many projects were built to meet foreign investors' demand, but the majority of domestic buyers could not afford to buy

[35] Prepared by Trung Thanh Vu, Associate Economist

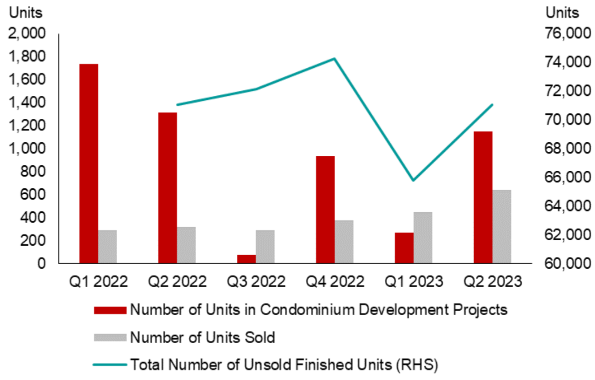
those houses. As a result, oversupply issues, especially in the high-end market, became evident after the pandemic broke out. The oversupply exists across many segments including condominiums and landed properties (Figure A1.3 and A1.4).

Figure A1.3. Supply and Transactions of Landed Properties



Source: Real Estate and Pawnshop Business Regulator of Cambodia, Non-Bank Financial Services Authority (NBFSA)

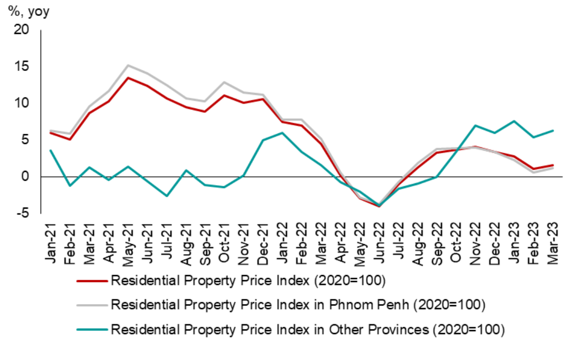
Figure A1.4. Supply and Transactions of Condominiums



Source: NBFSA

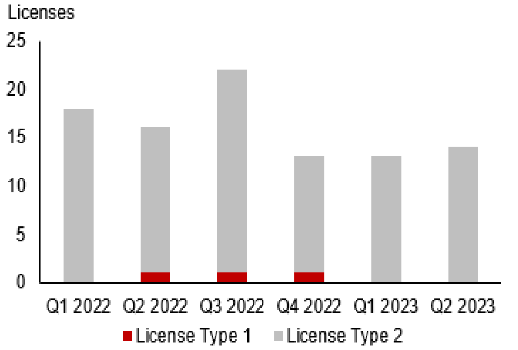
3. **Subdued demand and oversupply put pressure on property prices, while many developers choose to offer discounts rather than lowering tagged prices.** According to the NBC's official data, property prices declined sharply in Q2 2022, showed a slight upturn in Q4, but then decreased slightly in early 2023 (Figure A1.5). However, the price index developed by the NBC is based on banking transaction data which reflect only a part of the real estate markets. In contrast, real estate agents and associations anticipate a continued downward trend in housing prices unless the market conditions improve notably. Another reason that the price index is misaligned with subdued demand is that developers in the primary market frequently avoid lowering their sale prices, opting to offer larger discounts of up to 30 percent in 2023 compared to 10 percent in 2022.

Figure A1.5. Residential Property Price Index



Source: NBC

Figure A1.6. Real Estate Licenses by Type



Source: NBFSA

Developers' Financing Structure and Silent Threats from Shadow Banking

4. **"Shadow banking activities"[36], operated by developers have been active in the real estate sector.** Credit growth to the real estate sector reported by the NBC does not capture the informal financing provided by real estate developers to home buyers. These lendings are not under the supervision of either the NBC or NBFSA. Under the installment plans with

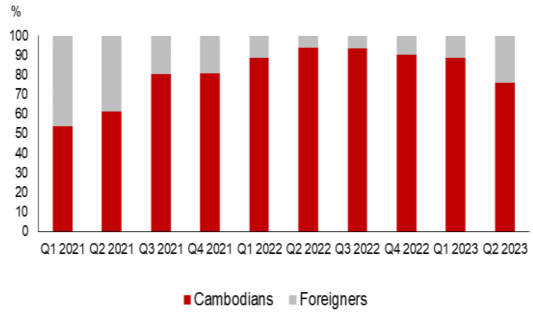
[36] In this context, "shadow banking activities" refer to the situation in which real estate developers are engaged in credit provision (mortgage loans) or are extending installment options to home buyers, which are not subject to the supervision of the NBC.

developers, home buyers are required to provide a downpayment of 20 percent to 30 percent of the house value, and the remaining amount can be financed through installments. Mortgage loans offered by developers come with mortgage rates of around 12.0-12.5 percent and can have a duration of up to 17 years, while mortgage loans offered by banks often come with rates of 8-9 percent for a 15-year term.

5. Many developers provide financing to home buyers under two types of licenses. Type 1 license is granted to developers who complete their construction before they sell their units. Type 2 license is granted to developers who start construction and sales of the housing units at the same time. The type 2 license holder enables developers to offer financing to home buyers, which has become common for real estate developers. There is no limit on the maximum deposit a customer can put down (Sangeetha 2022). A majority of developer licenses are type 2, while home buyers are mainly local ones (Figures A1.6 and A1.7).

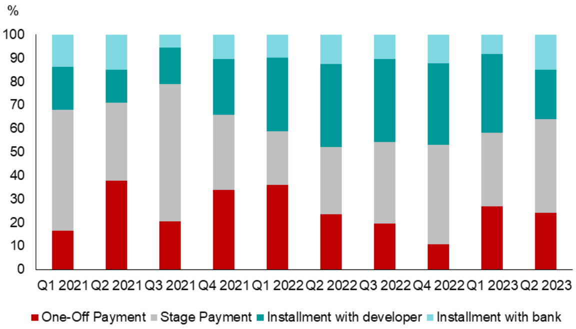
6. Developers offer various payment options for home buyers including one-time payment, stage payment, installments with developers, and installments with banks. Stage payments and installment plans with developers[37] remain popular choices among home buyers, accounting for 39.8 percent and 21.2 percent, respectively, as of Q2 2023 (Figure A1.8). Numerous developers have partnered with local banks to offer mortgage loans to their customers. Many home buyers find it more convenient to choose installment plans offered by developers rather than trying to borrow from banks because banks often have stricter credit assessments and require borrowers to provide income certificates that many Cambodians do not possess. Consequently, opting for financing through developers has become a more practical choice for many.

Figure A1.7. Share of Home Buyers by Residency



Source: NBFSA

Figure A1.8. Payment Options between Buyers and Developers



Source: NBFSA

7. Tensions have escalated between developers and home buyers amid the current downturn. On the buyers' side, defaults and late payments have increased as buyers struggled with their commitments to installment plans since late 2022 and early 2023. This has given rise to conflicts between home buyers and developers, as developers have resorted to confiscating buyers' properties due to late payments (Phoung 2023). Moreover, if a home buyer defaults, developers face potential losses when they are forced to sell the property. On the other hand, some developers have faced challenges in completing their projects and meeting the handover deadlines. Land ownership disputes have also emerged. For instance, some developers initiated their projects without finalizing land purchases or without having full ownership of the land. As a result, developers have been unable to transfer land ownership to home buyers, eroding trust among buyers. The Prime Minister recently urged developers to

[37] Stage payments are made at specific milestones or stages of a project, usually after the completion of predefined tasks or phases of construction. Installment payments with developers are a regular, fixed amount of money paid at scheduled intervals until a debt is paid off in full. Installment payments can be made on a monthly or quarterly basis and each payment can include both the principal amount and the interest accrued.

provide transparent payment contracts, although there currently exists no legal framework to enforce the provisions of such contracts.

8. Some developers face a credit crunch and are at risk of default. As some developers rely heavily on buyer installments to fund their projects, late payments have disrupted their cash flows. At the same time, banks have grown cautious about extending loans to real estate developers, leaving them vulnerable to a drying up of short-term funding during the market downturn. As a result, according to the NBFSA, as of Q1 2023, 63 percent of developers reported negative cash flows. To maintain cash flows, some developers have had to reduce staff, terminate contracts, and offer property discounts. However, larger developers enjoyed some resilience due to support from parent conglomerates, making them less prone to default compared to smaller developers. This has led some real estate agents to predict market consolidation, with some developers facing default. Furthermore, the financing practices between home buyers and developers are deemed unsustainable and pose financial instability risks, as defaults among developers can occur abruptly, unlike banks.

9. Credit risks associated with the real estate lending through the official banking system remain a concern. Cambodia has seen high credit growth to the real estate and construction sectors. At the end of 2022, credit to real estate and construction sectors accounted for one-fourth of total bank loans, while credit to the real estate, construction, and mortgage sectors accounted for about one-third of total bank loans (NBC 2022). This substantial exposure presents a potential for credit risks to exceed pre-pandemic levels in the traditional banking sector. As of the end of 2022, non-performing loans (NPLs) associated with real estate activities rank among the highest when compared to other sectors (Figures A1.9 and A1.10). Locally incorporated banks may face a further surge in NPLs in 2023 compared to 2022.

Figure A1.9. Non-Performing Loans by Sector

Source: NBC; AMRO staff calculations

Figure A1.10. Banks' Exposure to Real Estate Loans

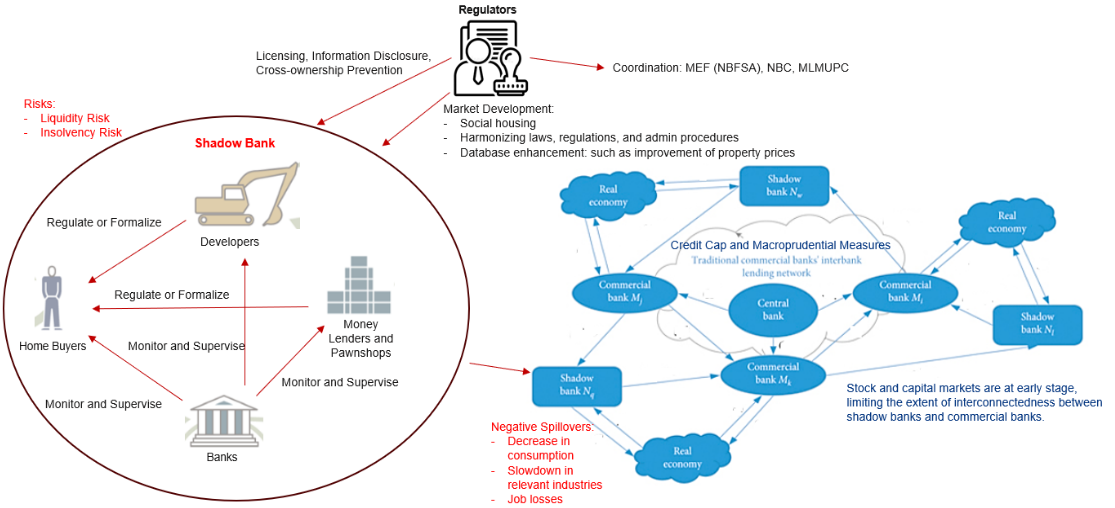
Source: NBC; AMRO staff calculations
Note: The number in parenthesis represents the percentage share of each bank's loans to the real estate and construction sector in total assets.

10. A back-of-the-envelope calculation indicates that the size of shadow banking linked to real estate lending is estimated at around 60 to 70 percent of GDP assuming a moderate level of interconnectedness between them.[38] Estimating the size of shadow

[38] Due to the informal nature of shadow banking activities and lack of information on the level of interconnectedness, the estimated size of shadow banking linked to the real estate sector ranges widely from 39 to 112 percent of GDP. The upper bound of 112 percent is rather an extreme case in which the interconnectedness between shadow banks and commercial banks is at a full level, while the low bound of 39 percent assumes no interconnectedness. However, the former case is unlikely to happen although

banking is challenging, especially when many home buyers still depend on informal lending practices with developers (Figure A1.11). To gauge the extent of shadow banking associated with real estate lending, we employ a back-to-the-envelope method, as detailed in the Appendix, by combining the currently available information on bank lending to the real estate sector with the share of home buyers' installment payments to developers. The potential interconnectedness between banks and real estate developers can result in a more pronounced credit risk shift from shadow banking to traditional banking, potentially leading to a surge in NPLs beyond what the NBC officially reports.

Figure A1.11. An Illustration of Shadow Banking and Real Estate Activities in Cambodia



Source: AMRO staff

11. The government has adopted timely policy measures to support real estate developers. Policy measures undertaken by the government in April 2023 are to help stabilize the real estate market. These supporting measures include tax exemptions and voluntary loan restructuring from banks to relieve financing pressure on developers. At the same time, new upcoming regulations such as Sub-Decree 50 issued on 2 March 2023 may help enhance the management of real estate development businesses to some extent. In particular, the Sub-Decree 50 will determine the rules and procedures for managing and inspecting real estate businesses in Cambodia. The Sub-Decree covers provisions on business operation, inspection, reporting, dispute resolution, and penalties for violation. A number of new and separate regulations are to be issued to implement provisions of this Sub-Decree. However, support measures will only provide temporary relief for developers, while the legal framework on shadow banking has not been completed. Hence, measures to stabilize and develop the real estate market must go hand-in-hand with more stringent oversight and supervision.

Controlling Risks while Setting Up a Legal Framework

12. Regulators should maintain a comprehensive and consistent approach in evaluating, granting, and managing licenses to real estate developers. Prakas No. 064, dated 27 December 2022, by the NBFSA, tightened the licensing of real estate services by reducing the validity of the licenses from three years to only one year. It is also necessary to strengthen regulatory compliance on financial reporting. On-site supervision and auditing are needed to enhance compliance. In addition, regulations can consider streamlining the

it cannot be completely excluded given unregulated shadow banking activities. To some extent, there exists some interconnectedness between shadow banks and commercial banks. If so, the size of the shadow banking may fall in the middle of the range, which is about 60-70 percent.

licensing process by implementing a single-window system or online platform for property licensing. Via the platform, developers should be required to regularly update the regulators on their financial soundness such as debt levels and other liquidity ratios. When developers violate any rules, it is necessary to institute specific penalties such as suspension of license and business permit, freezing real estate development accounts, freezing of business security deposit, and possible monetary fines.

13. **Adopting stringent regulations and vigilant monitoring are imperative to rein in lax lending practices by developers.** The government can consider setting a borrowing limit between home buyers and registered real estate developers by adopting a specific cap on the ratio of a loan to the value of purchased property. At the same time, the government can disclose a list of unregistered and unlicensed developers to the public and encourage people to borrow from banks. Home buyers who borrow from a financial institution should possess their property titles and enjoy protection against property confiscation without court permission. To ensure the prudent use of property transactions, banks should put the funds in escrow accounts that can only be withdrawn after the completion of the units. Lastly, the government can consider drafting detailed regulations and procedures for dispute resolution over property ownership and transactions.

14. **Establishing a centralized and standardized data management system in the real estate sector is essential in facilitating comprehensive analyses and data-sharing across regulatory bodies.** In this regard, the recent initiative taken by the Economic and Financial Policy Committee and the NBFSA for real estate market data sharing is an important step forward. It is necessary to expand the coverage of the property price index to better reflect market conditions. Concerted and effective coordination across regulatory bodies, particularly the NBC, Ministry of Economy and Finance, NBFSA, and the MLMUPC, will play a vital role in ensuring the successful implementation of these policy measures.

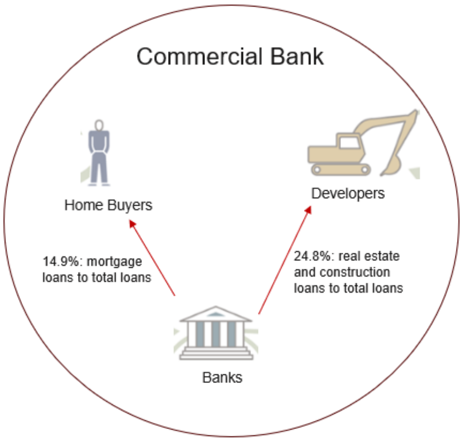
Appendix: Estimating the Size of Shadow Banking Activities Linked to Real Estate Lending

A back-of-the-envelope method is used to estimate the size of shadow banking associated with real estate lending. In this exercise, “shadow banking activities” refers to the situation in which real estate developers are engaged in credit provision (mortgage loans) or are extending installment options to home buyers, which are not subject to the supervision of the NBC.

The estimate follows a few steps: (i) determining key variables including information on payment options between home buyers and developers, and mortgage loans via the official banking sector; (ii) identifying a lower bound scenario in which the interconnectedness between official banking and shadow banking is assumed to be minimum and an upper bound scenario in which the interconnectedness between official banking and shadow banking is highly complex; (iii) making relevant key assumptions for each scenario, (iii) performing calculation by combining the currently available information on bank lending to the real estate sector; (iv) conducting cross-verification by comparing the estimate with other sources of information. Details are presented below.

Figure A1.12. An Illustration of Estimating Shadow Banking in Cambodia

Commercial Bank

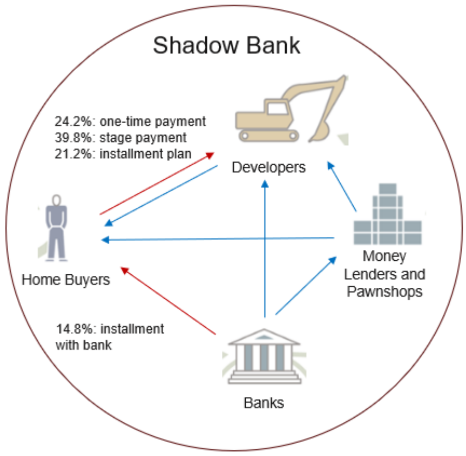


MB refers to mortgage loans.
TBL refers to total loans.

As of 2022,
$\frac{MB}{TBL} = 15\%$ and $\frac{TBL}{GDP} = 183\%$.

Thus, $\frac{MB}{GDP} = \frac{MB}{TBL} \times \frac{TBL}{GDP} = 15\% \times 183\% = 27\%$.

Shadow Bank



MSB refers to instalments with developers.
TSBL refers to total stock payments received by developer.

As of 2022, $\frac{MSB}{TSBL} = 21.2\%$.

Relevant assumptions are made to calculate $\frac{MSB}{GDP} = \frac{MSB}{TSBL} \times \frac{TSBL}{GDP}$.

For the lower bound, only two red arrows in the figure are assumed to exist. For the upper bound, both red and blue arrows are assumed to exist.

Source: AMRO staff

Estimating lower bound: the size of shadow banking associated with real estate is about 39 percent of GDP.

- Assumption L1: Home buyers have easy access to credit through developers and credit provision from developers is in the form of mortgage loans or installments. In addition, home buyers only borrow from developers and not from any other sources.
- Assumption L2: A home buyer only chooses to borrow either from banks or from developers and the amount of mortgage loans that a home buyer needs to borrow from a bank is equal to the amount that he/she needs to borrow from developers. The installments with banks account for 14.8 percent of total home buyers' financing with developers at the end of 2022 and early 2023, while mortgage loans via the official banking system accounted for 14.9 percent of total bank loans at the end of 2022. Additionally, installments with developers account for 21.2 percent of total home buyers' financing with developers, while loans to real estate and construction via the official banking system accounted for 24.8 percent of total bank loans. Given that households may use the biggest proportion of their incomes to pay either for stage payment and one-time payment, we can assume that the total amount of loans via banks is equal to the total stock amount of payments received by developers from buyers.
- Key rationales for estimating the lower bound: At the end of 2022, mortgage loans via banks accounted for 15 percent of total bank loans. Given bank credit is equal to 183 percent of GDP (Appendix 2, NBC 2022), mortgage loans account for 27 percent of GDP. At the end of Q2 2023, installment with developers accounts for 21.2 percent of all

financing options with developers. Therefore, the amount of informal lending between buyers and developers can be estimated at 39 percent of GDP[39] in this scenario.

Estimating upper bound: the size of shadow banking associated with real estate is about 112 percent of GDP.

- Assumption H1: Developers, especially large developers, have a connection with banks, in some form such as cross-ownership, partnership, or borrowing relationship. As developers may have good relationship with banks, they can borrow at a moderate rate and extend credit to customers at a higher interest rate.
- Assumption H2: Home buyers borrow not only from developers but also from other sources such as banks, pawnshops, money lenders, and other sources.
- Key rationales for estimating the upper bound: In this case, stage payment can also be part of shadow banking in addition to monthly installments with developers. The stage payment accounts for 39.8 percent of all financing options. Therefore, the size of shadow banking can be estimated at 112 percent of GDP[40] in this scenario.

The estimate based on the back-of-the-envelope method is in line with other studies in literature. For example, Medina and Schneider (2018) estimated that the size of Cambodia's shadow economy in Cambodia was equal to 46 percent of GDP over the period 1991 to 2015.

Although this method can provide a basic understanding of shadow banking in Cambodia, it has certain caveats. Because the rough calculation relies heavily on assumptions, any changes in assumptions can lead to changes in results. Moreover, shadow banking is dynamic and evolves over time. The back-of-the-envelope estimates are based on static historical data and may not capture all dynamic changes.

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[39] The lower bound is equal to $\frac{MSB}{GDP} = \frac{MSB}{TSBL} \times \frac{TSBL}{GDP}$. Given the assumption of $TBL = TSBL$, $\frac{MSB}{GDP} = \frac{MSB}{TBL} \times \frac{TBL}{GDP} = 21.2\% \times 183\% = 39\%$.

[40] The higher bound is equal to $\frac{MSB}{GDP} = \frac{MSB}{TSBL} \times \frac{TSBL}{GDP}$. Given the assumption of $TBL = TSBL$, $\frac{MSB}{GDP} = (21.2\% + 39.8\%) \times 183\% = 112\%$.

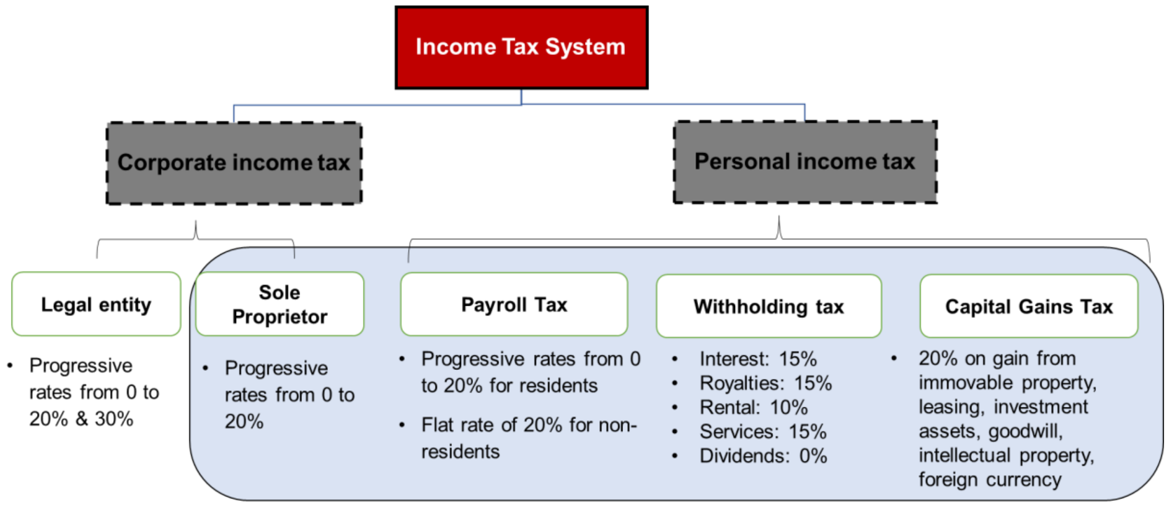
Annex 2. Implementing a Comprehensive Personal Income Tax System in Cambodia[41]

In Cambodia, the tax revenue generated from the personal income tax (PIT) consistently remains lower than other taxes, primarily due to the absence of a comprehensive regulatory framework. In March 2023, Cambodia adopted a policy framework to prepare for the implementation of PIT. However, detailed policies and administrative measures still need to be determined, particularly on setting the liability threshold and a simplified tax return procedure. This Selected Issue reviews the recent policy development of PIT, with the aim of providing key policy considerations for its effective implementation in Cambodia.

Background

1. The current income tax structure in Cambodia is fragmented with a scheduler system, and there is no specific law or regulation dedicated solely to personal income tax (PIT). The income tax system was implemented after the first introduction of a law on taxation in 1997. Cambodia continued to practice the final withholding tax on taxable incomes without annual tax declaration despite the abolishment of the estimated tax regime to adopt a self-declaration regime in 2016. Differing from other countries, the income tax system in Cambodia mostly refers to corporate tax income due to the non-existence of the PIT. Although Cambodia has been collecting taxes related to personal income, including payroll tax, tax on fringe benefits, withholding tax on technical service, interest, dividends, royalties, and other income (Figure A2.1), the contributions to total tax revenues have remained very low. In addition, a capital gains tax was introduced in 2020, but its implementation has been postponed till the end of 2023, mainly due to the COVID-19 pandemic.[42]

Figure A2.1. Overview of Cambodia's Income Tax System



Source: Ministry of Economy and Finance; AMRO staff illustration

2. Cambodia has embarked on a path to a comprehensive income tax system with the adoption of a long-term policy framework[43] in March 2023. The adopted policy framework paved the way for the implementation of a PIT. Although Cambodia has practiced a self-declaration tax regime, the practice of applying a final withholding tax on personal taxable incomes without annual tax declaration undermines tax compliance and revenue collection from personal income. Thus, the new framework aims to establish a

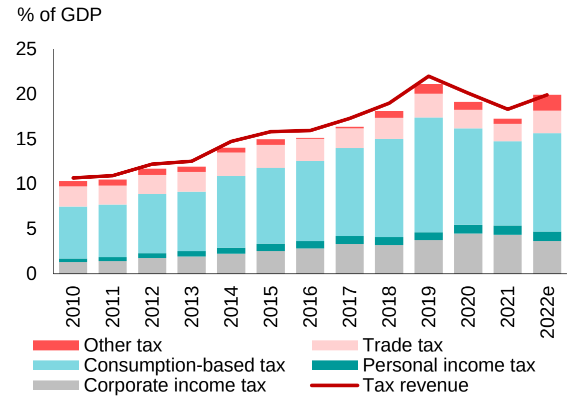
[41] Prepared by Monineath El, when he was seconded to AMRO as an Associate.
[42] The implementation of a capital gains tax has already been delayed for three times (in 2020, 2021, 2022) due to the pandemic.
[43] Ministry of Economy and Finance (2023a), "Policy Framework on the Preparation for the Implementation of Personal Income Tax".

modern and comprehensive PIT system that aligns with Cambodia's socio-economic development agendas, with the implementation in phases. The framework outlines the vision for the PIT system and provides guidance on policy and administrative measures. The newly adopted policy framework will have significant implications for Cambodia's income tax system, particularly in determining the model for the PIT system, establishing institutional arrangements, and defining regulatory framework requirements. The framework does not provide detailed information on each component, but an upcoming action plan for implementing this framework will provide detailed plans and a specific timeframe. Against this backdrop, this Selected Issue looks at the recent development of the PIT policy framework, including a capital gains tax, while aiming to provide key policy considerations for implementing Cambodia's PIT system to fill the gaps in the policy framework.

Recent Developments of Personal Income Tax

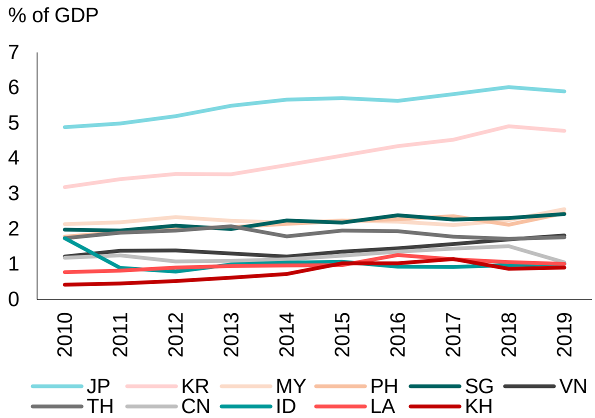
3. Revenue collection from PIT remains low compared to revenue from other types of taxes despite remarkable revenue mobilization over the years. Cambodia's tax revenue is largely dominated by consumption-based tax, while revenue from PIT has only contributed an average of 0.8 percent of GDP between 2010 and 2019 (Figure A2.2). These are likely due to the lack of a comprehensive regulatory framework to enforce revenue collection from personal incomes and a longstanding practice of applying final withholding tax on personal incomes without annual declaration. PIT revenue collection in Cambodia is lower than in all other ASEAN+3 economies (Figure A2.3). Against this backdrop, the adoption of a policy framework will likely allow the Cambodian government to mobilize a potential source of domestic revenue.

Figure A2.2 Cambodia's Tax Revenue Decomposition



Source: Ministry of Economy and Finance; AMRO staff calculations (2022)

Figure A2.3 PIT Revenue as a Share of GDP in ASEAN+3 Economies



Source: World Revenue Longitudinal Data (2022)
Note: No data available for Brunei and Myanmar

4. As indicated in the framework, imposing a capital gains tax, effective from January 2024 onward, will become a milestone for implementing a comprehensive PIT system. Although capital gains tax still awaits implementation, mobilizing revenue from capital income will increase the existing PIT's revenue collection from employment and business income from sole proprietors of the individuals as well as broaden the personal income tax base. The capital gains tax applies a flat rate of 20 percent on the sale or transfer of immovable property, leases, investment assets, goodwill, intellectual property, and foreign currencies. Besides the method of actual expense deduction, the determination-based method will bring the effective tax rate of capital gains tax to 4 percent.[44] Compared to regional peer economies that have applied a schedular rate on each type of capital income, a flat tax rate on capital gains in Cambodia can hinder capital asset transactions with less incentive for investments in financial securities, which could become a potential obstacle to revenue mobilization from some types of financial assets as a new tax base in the medium term (Table A2.1).

Table A2.1. Capital Gains Tax on Individuals in Select ASEAN+3 Economies

Country	Immovable Property	Leasing	investment asset	Franchise	IPR	Foreign currency	Others
KH	20% (Effective tax rate of 4%)						
ID	2.5%	-	-0.1% (gain on shares) -0.5% (share value)	-	-	-	-5% to 35% (subject to personal income tax rate)
MY	- 0% (disposals from 6th Year) - 15% (5th Year) - 20% (4th year) - 30% (up to 3 years)	-	-	-	-	-	Gains on capital assets are not subject to tax, except for disposal of real property
MM	10%						Different rate applied for upstream oil and gas activities
PH	6%	-	-0.6% (gross selling price) -15% (net gain of unlisted shares)	-	-	-	-
SG	no tax on capital gains						-
TH	-5% to 35% (subject to personal income tax rate) -Exemption for on the sale of shares/security/non-interest baring debentures						-
VN	5% to 35% (subject to personal income tax rate)						-
JP	- 20.315% (over 5 years) - 39.63% (less than year)	-	20.315%	-	-	-	-
CN	20% on capital gains on other personal income						-
KR	- 6% to 45% (subject to individual's taxable income) - 22% to 27.5%/33% on stake of a shareholder - 20% for transfer of the stocks						-

Source: PWC (2022); AMRO staff compilation
Note: "-" = Not available

5. However, the ongoing weakness in the construction and real estate sectors has prompted growing concern about the implementation of a capital gains tax. In recent times, there has been concern among taxpayers and real estate investors around the planned implementation of a capital gains tax. This is owing to the slow recovery in the construction and real estate sectors amid the sluggish rebound of foreign capital inflows, especially Chinese investment, and reflecting the decline in imports of construction materials and local cement production in the first seven months of 2023. In particular, the recent announcement by the tax authority, emphasizing the planned implementation of the capital gains tax raises questions on the government's fiscal policy stance amid a slow recovery of key and backbone sectors of the economy.[45]

Policy Considerations in the Implementation of a Personal Income Tax

6. In terms of the choice of a PIT system, adopting a dual tax system is an option consistent with the income tax provisions. Considering two types of income tax systems, namely the global income tax and the schedular income tax, the government's newly adopted policy framework proposes a "schedular" income tax system at the early stage of implementation to avoid a drastic change in the income tax system and provide flexibility for tax administration. This income tax system determines separately gross income and deductible expenses based on each source of income and imposes separate taxes on different sources of income. Although this tax system can somehow achieve horizontal equity, it still has a number of disadvantages including administration costs, risk of tax planning, and

[44] The determination-based method allows an 80 percent deduction of the sale proceeds instead of paying tax on 100 percent of the gain.
[45] See Ministry of Economy and Finance (2023b), according to which, the government expects to collect 375 billion riels (approximately USD 93 million) from capital gains tax in 2024.

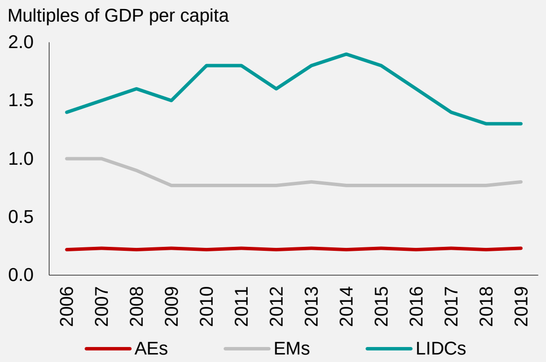
economic inefficiency. Meanwhile, the global income tax system that imposed a single tax schedule on all taxpayers' income regardless of their sources of income improves the equity of the tax system owing to its progressive tax rate structure and disincentivized tax arbitrage. However, it possibly generates high marginal rates on capital income. The optimal solution is a dual tax system that typically taxes labor and business income at progressive rates and capital income at a flat rate.

7. An appropriate level of progressivity in the PIT rate can ensure more equitable income distribution. Despite the inequity of taxation of a schedular income tax system, the gradual transition to a global income tax system will reduce the policy gap of breaching the horizontal equity principle of the tax system as two individuals with the same aggregate income but different combinations of sources of income are taxed differently under a schedular income tax system. However, setting multiple tax brackets in either a schedular or a global income tax system likely has significant implications for progressive taxation as the many brackets would distort tax compliance, and the marginal tax rate will influence taxpayers' behavior. Hence, the authority must determine the appropriate level of tax bracket to achieve progressive taxation. Prior to that, setting the PIT's minimum liability threshold at an appropriate level (See Box A2.1. Consideration of PIT's Liability Threshold) should be a key consideration in ensuring the threshold will not burden low-income earners.

Box A2.1. Consideration of PIT's Liability Threshold

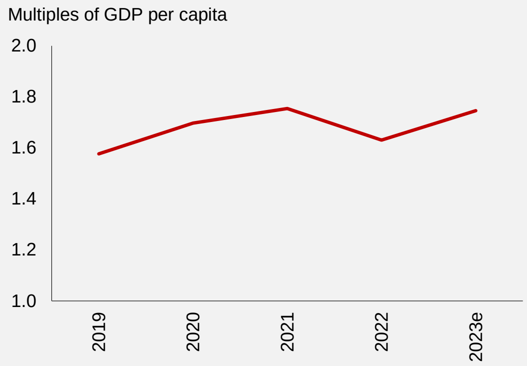
Determining PIT's liability threshold might be a challenging task for policymakers. The threshold is a crucial policy tool to relieve low-income earners from the burden of the PIT, and it differs from country to country based on the socio-economic development stage a country is at. On average, an individual with a PIT obligation in Low-Income Developing Countries (LIDCs) needs to earn an income that is at least 1.3 times GDP per capita in 2019, compared to 0.8 in Emerging Market Economies (EMEs) and 0.2 in Advanced Economies (AEs). Notably, the threshold in LIDCs was somewhat more variable from 2006-2019, compared to EMEs and AEs, with the threshold for PIT reaching a maximum of 1.9 times GDP per capita in 2014 (Figure A2.1.1).

Figure A2.1.1. Evolution of the PIT's Liability Threshold (in multiples of GDP per capita)



Source: Benedek, Benítez and Vellutini (2022)

Figure A2.1.2 Cambodia's PIT Liability Threshold (in multiples of GDP per capita)

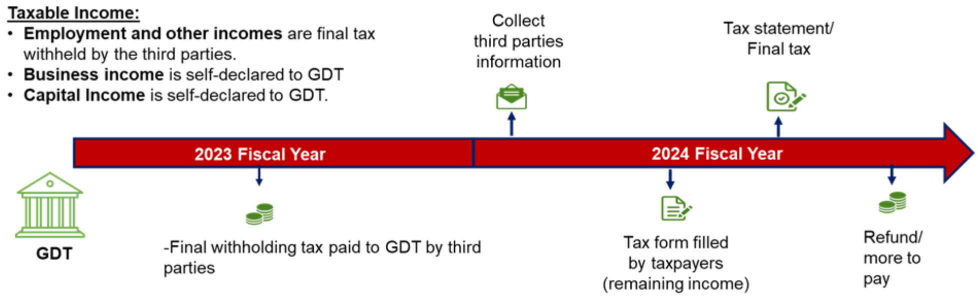


Source: AMRO staff estimation
Note: New GDP rebase (2014) with an assumption of 34 percent change in GDP per capita

Cambodia's PIT's liability threshold (including only the threshold of tax on salary and corporate income tax on sole proprietors) is variable between the above LIDCs benchmark at an average of 1.7 times GDP per capita during the period of 2019-2023 (Figure A2.1.2). However, the newly adopted PIT policy framework will likely set out additional PIT's taxable income, including tax on capital income, royalty income, interest income, pension, and dividend income, which will have a significant implication on the threshold. In addition, Cambodia is witnessing rapid GDP growth, which will push up its GDP per capita to reach its development goal as a high-income country by 2030. Therefore, periodic reviews of the PIT's liability threshold should be conducted to ensure conformity with the country's socio-economic development and tax policy principles.

8. A simplified tax return procedure will encourage compliance with the personal income tax implementation. Under the modernization plan, Cambodia's tax authority has successfully implemented an e-filing platform for annual tax returns, reflecting a high rate of e-filing at 85 percent.[46] This suggests that the implementation of the e-filing platform for PIT is highly feasible. Cambodia has a self-declaration tax regime in place; however, it still employs the practice of applying a final withholding tax on individual taxable incomes without filing annual tax returns. Thus, it should be considered whether annual PIT return should be adopted or not. In case an annual PIT return is required, it will be a significant change that will burden taxpayers and tax officials, potentially impacting compliance. However, a simplified tax return procedure could be considered by continuing with the practice of applying a final withholding tax on employment income and other related income, while business and capital income can be self-declared at the time of filing an annual tax return (Figure A2.4). In this regard, the tax authority must carefully consider which tax return option is suitable for the effective implementation of a PIT.

Figure A2.4. Consideration of PIT Return Procedure



Source: AMRO staff illustration
Note: GDT = General Department of Taxation

9. In keeping with recent developments in the construction and real estate sectors, a careful review of the timeframe for implementing a capital gain tax should be considered. Although the policy framework seeks a capital gains tax to be implemented in 2024, aligning with the government's fiscal consolidation policy to build a fiscal buffer, imposing a new tax at this time could slow down the recovery of the construction and real estate sectors. Additionally, a capital gains tax is a new tax for Cambodian people – that will require a strong social capital and coordination between tax officials and taxpayers to ensure effective implementation. Therefore, the authority should focus on the dissemination of the guidelines for tax compliance and obligations of taxpayers on the one hand, and on the other, it should review the timeframe for suitable implementation.

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[46] See Ministry of Economy and Finance (2022).

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Annex 3. Establishing a Deposit Protection Scheme in Cambodia[47]

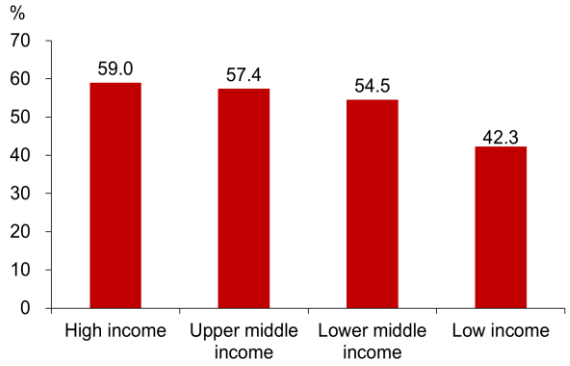
Given the significance of a deposit protection scheme (DPS) in preserving financial stability, the establishment of a DPS in Cambodia is deemed imperative, considering the country's expanding financial sector and the increasing digitalization of banking services. This Selected Issue conducts a simulation exercise to assess the impact of the DPS under different scenarios of bank insolvency. It is advisable to institute a comprehensive DPS covering both local and foreign currencies, with initial supervision by the central bank, at the earliest opportune time to bolster confidence in the banking sector, even with relatively low premiums and low coverage limits.

Background

1. **The deposit protection scheme (DPS) can be a pivotal safety net that significantly contributes to the preservation of financial stability in Cambodia.** Robust empirical evidence highlights the critical role of DPS in safeguarding depositor funds, maintaining confidence of depositors within a banking system, and mitigating the risk of systemic crisis.[48] Separately, the proliferation of internet-based access to financial systems has amplified the potential for bank runs during periods of crisis. Notably, failures within the financial sector, including bank insolvencies, have occurred with increasing frequency, paralleling the widespread adoption of internet banking facilitated by technological advancements.[49]

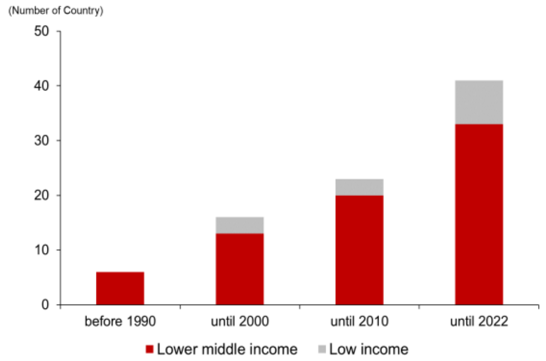
2. **This trend is underscored by the gradual expansion of countries embracing DPS**, increasing from just 16 jurisdictions in the 1980s to a significant 109 as of June 2023. Remarkably, countries with higher income levels are found to have introduced more DPS, and more than half of high-income, upper middle-income and lower middle-income countries have introduced deposit insurance systems (Figure A3.1). Among middle-income and lower-income countries, a grouping that Cambodia belongs to, only six had introduced until 1989, but this number has increased significantly to 41 countries as of the end of 2022 (Figure A3.2).

Figure A3.1 Adoption of Deposit Insurance by Income Level



Source: International Associations of Deposit Insurers (IADI); World Bank; AMRO staff calculations
Note: The classification of income levels uses World Bank data. The World Bank classifies income groups according to Gross National Income (GNI) per capita, with the threshold for high-income countries set at USD13,486. Some high-income countries located in the Caribbean area, South America, and the Middle East do not have deposit insurance yet.

Figure A3.2 Trends of Deposit Insurance Adoption among LMI and LI Countries



Source: IADI; World Bank; AMRO staff calculations
Note: 'LMI' and 'LI' represent lower middle income and lower income countries, respectively.

[47] Prepared by Jungsung Kim, Economist; Sopheawattey San, Associate; and Chunyu Yang, Associate Economist.
[48] Diamond and Dybvig (1983), Carisano (1992) state that preventing a bank run is the main reason for the existence of a DPS as it creates safety in the banking system.
[49] The BIS has mentioned the need for policy responses, such as strengthening the deposit protection system to maintain the stability of the financial system, as digital bank runs may develop rapidly at a faster rate in the future due to technological advancements (Restoy, 2023).

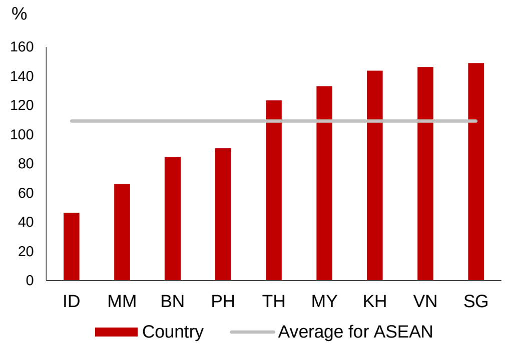
3. Moreover, deliberations aimed at fortifying deposit insurance mechanisms are currently on going in a few ASEAN+3 economies. In June 2023, the Monetary Authority of Singapore unveiled a proposed amendment to augment the deposit coverage limit, while in September 2023, the Hong Kong Deposit Protection Board introduced a comprehensive proposal aimed at enhancing the deposit insurance framework. This includes substantial revisions to the deposit coverage limit. Despite its importance, Cambodia has not yet introduced a DPS. Against this backdrop, this Selected Issue examines why it is important to introduce DPS in Cambodia and summarizes recent progress related to DPS in the country. The subsequent sections delve into issues that need to be addressed when introducing DPS in Cambodia with a simulation on the effectiveness of the DPS handling possible bankruptcy in different scenarios. This is followed by policy implications.

Key Rationales for Advancing a DPS in Cambodia

Sizable Financial System

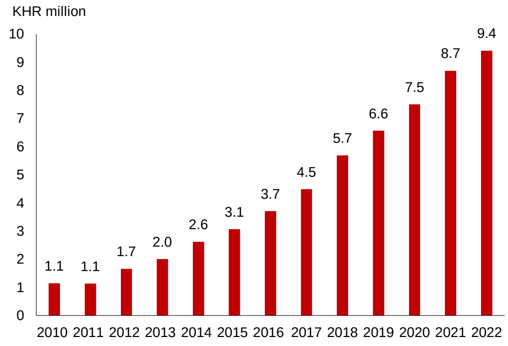
4. Given the growing financial sector in Cambodia, establishing a DPS will help to fortify the financial stability. As Cambodia has seen rapid economic growth, the financial sector's share in the country's economy has grown even more rapidly. The broad money, largely composed of deposits, has surged from 41.6 percent in 2010 to a notable 142.1 percent in 2022, positioning Cambodia with a relatively high level of broad money to GDP ratio among ASEAN nations (Figure A3.3). Moreover, the per capita deposit size has grown rapidly, increasing by 8.2 times, from KHR1.1 million per capita in 2010 to KHR9.4 million per capita in 2022 (Figure A3.4).

Figure A3.3 Broad Money-to-GDP ratios in Selected ASEAN Countries



Source: World Bank; central banks
Note: Lao PDR is excluded due to data unavailability. BN = Brunei; KH = Cambodia; C = China; HK = Hong Kong, China; ID = Indonesia; JP = Japan; KR = Korea; MY = Malaysia; MM = Myanmar; PH = Philippines; SG = Singapore; TH = Thailand; VN = Vietnam. Data for Myanmar, Philippines, and Singapore is as of 2020. Data for Thailand is as of 2019. Data for other countries is as of 2021.

Figure A3.4 Trend of Per Capita Deposit in Cambodia



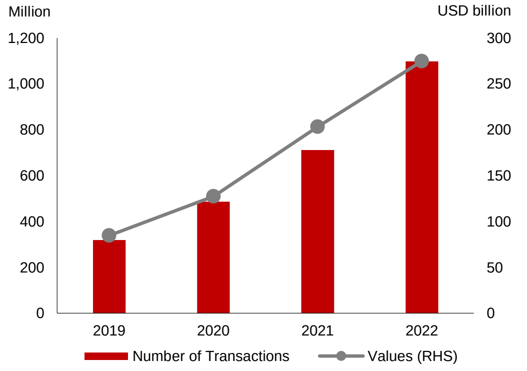
Source: NBC; Worldometer; AMRO staff calculations

5. Additionally, Cambodia's banking landscape is predominantly characterized by depository institutions, encompassing commercial banks and microfinance deposit-taking institutions (MDIs). This swift expansion of the financial sector, coupled with the growing deposit sizes, highlights the potential risks arising in the event of financial institution bankruptcies, which could reverberate across the economy and jeopardize household financial stability. It is noteworthy that within the ASEAN region, Cambodia and Myanmar are the only two countries that have yet to implement a DPS. As Cambodia's financial sector develops, a DPS has become more important in helping to maintain confidence in the banking system. undertaking to proactively mitigate potential financial risks and bolster the overall stability of the economy.

Rapid Digitalization of Financial Services

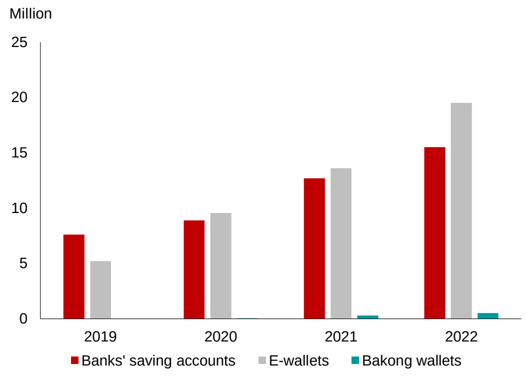
6. The rapid digitalization of financial services in Cambodia underscores the urgent need for the regulators to take measures to address potential digital bank runs. This urgency is primarily driven by Cambodia's distinctive population characteristics with a large young population that readily embraces digital technology. Moreover, the adoption of digital banking in Cambodia has been accelerated by the influence of social distancing measures. By the end of 2022, the NBC has granted licenses to 35 payment service institutions (PSIs) and two banks and financial institutions to operate payment operations. According to the NBC, the total volume of electronic payments has surged from USD85 billion in 2019 to USD274 billion in 2022, almost 10 times the size of GDP, while the number of transactions has risen to one billion compared to 708 million in 2021 (Figure A3.5). Notably, digital accounts, including e-wallets with Cambodian banks, have witnessed remarkable growth, from 2.3 million in 2013 to an impressive 20 million in 2022 (Figure A3.6). While the digitization of financial services undoubtedly enhances convenience for users, it concurrently intensifies the risk of bank runs, and could amplify financial instability in response to any shock to the financial system.

Figure A3.5 Payment Transactions and Value



Source: NBC; AMRO staff calculation

Figure A3.6 Trend of Bank Accounts, E-wallets, and Bakong Wallets



Source: NBC; AMRO staff calculations

7. Given these trends, it is necessary to effectively mitigate digital bank runs by fortifying deposit insurance mechanisms. Recent research examining historical banking crises has revealed a stark shift in the withdrawal period for depositors. During the GFC, this period increased from 16 to 19 days, whereas with the advent of digital banking, it has been dramatically compressed to within a mere 2 days.[50] As Cambodia's Digital Economy and Social Policy Framework for 2021-2035, devised by the National Economic Council and launched in May 2021, continues to propel the digitalization of financial services, it is important to proactively institute measures to counteract the unintended consequences of digitalization.

First Line of Defence for Foreign Currency Deposit

8. Given the economy's high level of dollarization, a build-up of foreign currency funds for DPS could help in addressing potential bank runs. In many countries, the central bank can act as the lender of last resort by injecting liquidity into the bank when there is a bank run. However, since most deposits in Cambodia are in U.S. dollars, the NBC has to use foreign reserves if the DPS itself is not large enough to cover deposits, which may affect Cambodia's external soundness. That said, the ability of the DPS to manage potential bankruptcies will strengthen as the fund grows through annual contributions from participating financial institutions.

[50] For more details, refer to Rose (2023).

9. We conducted a simulation exercise to quantify the dynamic impact of establishing a DPS on deposit protection in different scenarios involving bank insolvency. To this end, we assume that the DPS fund will be established in 2024 under a set of alternative scenarios with two premium options (high premium at 0.46 percent of deposits, and low premium at 0.18 percent of deposits) and three coverage limit options (high ceiling at 3.8 percent of GDP per capita, medium ceiling at 2.0 percent, and Low ceiling at 1.6 percent), as summarized in Table A3.1. High premium level is set to the average of highly dollarized economies including Argentina, Ecuador, El Salvador, and Peru, while the low premium is the average of selected ASEAN countries including the Philippines, Indonesia, and Vietnam. High and medium coverage limits are set to the average of the coverage ceilings in developing economies and developed economies respectively, based on Laeven (2002). Meanwhile, low coverage limit is set to be equal to the average size of deposits per account in Cambodia. We then apply three bankruptcy shocks according to the size of insolvent banks, which is based on the distribution of the share of deposits by individual commercial banks and MDIs in Cambodia (Figure A3.7).[51] This simple exercise has a limitation in that it cannot take into account spillover effects, as it is assumed that only one bank is insolvent at a time. The results from our simulations show that:

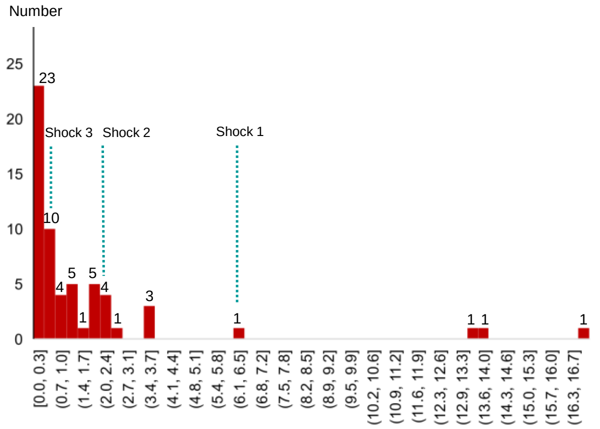
- The DPS fund alone cannot cover the protected deposits when a large bank becomes insolvent – which is a tail risk – even with a high premium and six years of accumulation (Figure A3.8, (a)).
- However, when a high premium is applied, the DPS fund can cover insolvency occurring in any individual bank ranking 10th or lower after six years of accumulation, with a median coverage limit, or within five years with a low coverage limit (Figure A3.8, (c)).
- Even starting with a low premium, as long as the coverage limit is medium or low, the DPS fund can cover insolvency occurring in any individual small bank ranking 30th or lower, right after the establishment of the fund (Figure A3.8, (f)).

Table A3.1 Simulation Assumptions

	Definition	Type	Value	Reference
Premium	The annual fees banks pay to the DPS	High	0.46% of deposits	Average of highly dollarized economies
		Low	0.18% of deposits	Average of ASEAN peers
Coverage limit	The maximum amount of money that will be reimbursed per bank account by the DPS in the event of a bankruptcy	High	3.8 of GDP per capita	Average of developing economies
		Medium	2.0 of GDP per capita	Average of developed economies
		Low	1.6 of GDP per capita	The size equals to the average deposits per account in Cambodia
Shock	An event of a bankruptcy	Shock 1	Large bank fails	Bankrupt happens in a bank that ranks 4th among deposit takers
		Shock 2	Medium bank fails	Bankrupt happens in a bank that ranks 10th among deposit takers
		Shock 3	Small bank fails	Bankrupt happens in a bank that ranks 30th among deposit takers

Source: AMRO staff illustration
Note: 1) Banks mentioned here include commercial banks and MDIs.
2) The premium reference comes from each country's deposit

Figure A3.7 Histogram of Share of Deposits



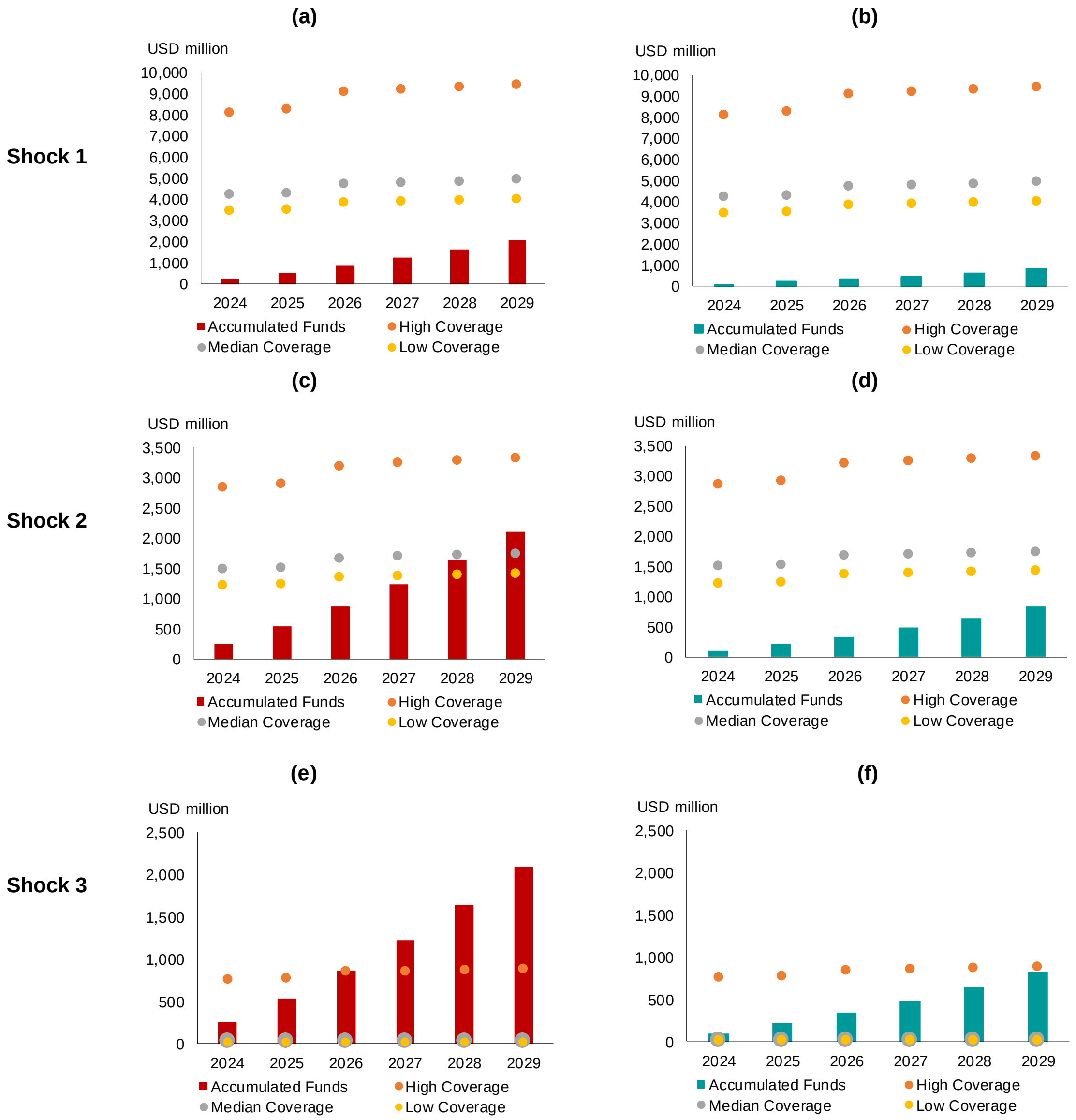
Source: NBC, AMRO staff calculation
Note: Banks mentioned here include commercial banks and MDIs

[51] In the context of the large bank failure scenario, it is important to note that the deposit sizes of the top four banks in Cambodia, as illustrated in Figure A3.7, are significantly larger than those of the others. Therefore, we choose the bank ranked 4th for simulating the failure of a large bank. If the DPS is unable to cover this bank, it would also face challenges in covering the top three banks. Regarding the small bank failure scenario, the left-skewed distribution highlights the concentration of small banks in Cambodia. To simulate the failure of a small bank, we choose the bank ranked 30th, which corresponds to the median. If the DPS is sufficient to cover this bank, it indicates that the smaller half of the banks within the system can be covered successfully. For a medium bank failure scenario, we select a bank ranking between 4th and 30th. This allows us to assess the adequacy of the DPS in covering banks of moderate size.

insurer. High premium is the average of highly dollarized economy and low premium is the average of some ASEAN countries. The high and medium coverage limit reference comes from Laeven (2002).

Figure A3.8 Simulation Results of Bankruptcies Under Different Scenarios

High Premium | **Low Premium**



Source: AMRO staff calculations and projections
Note: 1) This simulation includes commercial banks and MDIs. 2) In every chart, all dots represent the maximum amount of deposits that need to be covered by the DPS fund when a bankruptcy occurs in a certain year. If the dot is higher than the bar, which represents the accumulated size of the fund, it means the DPS fund alone cannot cover the deposits. If the dot is lower, it means that the DPS fund is large enough to cover the deposits. 3) Deposit growth, population growth, total bank accounts, and exchange rate are based on AMRO staff assumptions.

Policy Implications

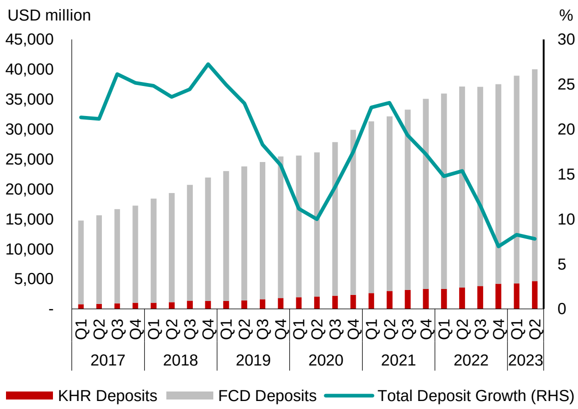
10. As part of its crisis prevention and management framework, the NBC is exploring the possibility of establishing a DPS to strengthen the financial safety net. In line with the Financial Sector Development Strategy 2016-2025 and the Law on Banking and Financial Institutions, the NBC has established an internal Deposit Protection and Bank Resolution Unit at the end of 2020. The unit is mainly in charge of conducting a feasibility study on the establishment of a DPS in Cambodia. Meanwhile, a working group on deposit protection mechanism has also been formed, led by the NBC with representatives from the Ministry of

Economy and Finance. Notably, key stakeholders in Cambodia's financial sector, including private banks, credit rating agencies, and private economic research institutes, all share an awareness of the critical role that the DPS can play in increasing public confidence in the banking system and ensuring financial stability. At this nascent stage of DPS implementation, specific measures have not been confirmed yet.

11. The need to protect foreign currency-denominated deposits is significant. In Cambodia, around 90 percent of financial institutions' deposits are in US dollars as of 2022 (Figure A3.9). If the DPS only protects the local currency, it would provide little benefit to depositors. Notably, the global trend regarding the application of insurance to foreign currency deposits is to apply insurance to all deposits regardless of their currency of denomination. According to a survey by the International Association of Deposit Insurance (IADI), as of 2022, 73 percent of its member countries apply deposit insurance to foreign currency deposits. Several highly dollarized countries in South America, such as Argentina, Peru, and Uruguay, offer protection not only for their domestic currency but also for foreign currencies.

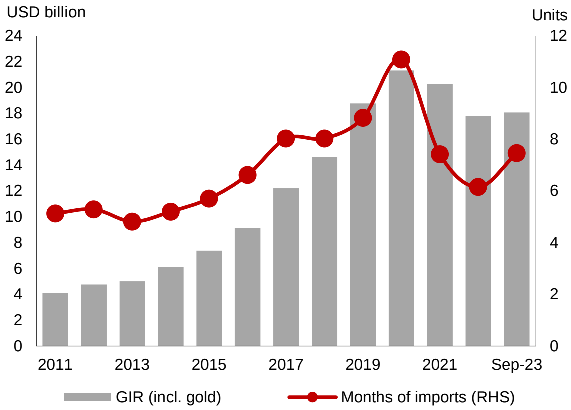
12. However, it is equally important to prepare for potential side effects. Protecting foreign currency deposits can hinder efforts to increase the use of domestic currency usage. Additionally, in cases where the DPS needs to use foreign reserves to guarantee foreign currency deposits, there may be concerns that external financial soundness may be weakened. Cambodia's external sector is relatively stable with international reserves amounting to USD18.7 billion as of July 2023, relatively large for a low-middle-income country (Figure A3.10). Given the economy's high level of dollarization, it would be inevitable for DPS and the NBC to protect foreign currency-denominated deposits. But, it is equally imperative to devise strategies to address potential side effects, such as the safeguarding of external financial soundness.

Figure A3.9 Total Deposits and Deposits by Currency



Source: NBC; AMRO staff calculations

Figure A3.10 Gross International Reserves



Source: NBC; AMRO staff calculations

13. It is advisable to establish a DPS at the earliest opportune time to help enhance confidence in the banking sector, even with relatively low premiums and low coverage limits. To facilitate a smooth start, the fund can begin with a relatively low coverage limit and a uniform low premium across different currencies and banks. This approach is feasible for dealing with small bank runs, as indicated by our simulation results. It can gradually implement higher insurance coverage limits, or impose higher insurance premium rates for deposits denominated in foreign currency or differentiate premium rates based on banks' risk of bankruptcy. A well-funded deposit insurance fund is better prepared to handle crises and mitigate the adverse effects of banking sector vulnerabilities. Furthermore, early implementation can serve as a strong measure to prevent bank runs and financial panics, as the mere existence of such a scheme can deter depositors from engaging in panic withdrawals during times of uncertainty.

14. Achieving a harmonious balance between international standards and country-specific economic conditions is of paramount importance when introducing a DPS. The IADI has outlined 15 core principles concerning deposit insurance systems.[52] It is worth noting that the preliminary DPS plan may not necessarily fully align with all those core principles articulated by the IADI. For instance, the IADI's third principle relates to governance and emphasizes that the deposit insurance institution should function independently, free from interference by other government agencies. Operating independently offers the advantage of supervising deposit-taking financial institutions without being influenced by political considerations and enables the institution to effectively utilize its deposit insurance capacity when early signs of bank runs emerge. However, a prerequisite for this independence is that the deposit insurance institution possesses adequate capacity in terms of financial institution oversight, budget management, and skilled human resources.

15. In this context, a newly established DPS can be initially placed under the supervision of the NBC for operational efficiency. Considering that the NBC's mandate is not only for price stability but also banking and payment system's oversight and supervision, it may be more operationally efficient to initially place the deposit insurance institution within the central bank during the initial stages. This decision is motivated by the recognition that the insurer must possess an in-depth understanding of the intricacies of the financial system and possess the capacity to supervise financial institutions effectively. This arrangement can also capitalize on the central bank's existing infrastructure and expertise, facilitating a smoother transition.

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[52] The core principles were announced jointly by the Basel Committee on Banking Supervision (BCBS) and the International Association of Deposit Insurers (IADI) on 18 June 2009. The IADI website provides more details.

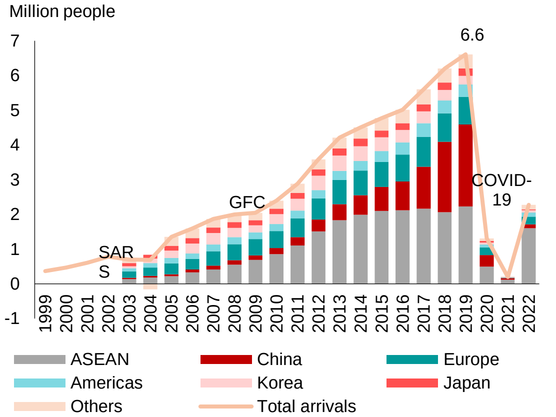
Annex 4. Structural Challenges in the Tourism Sector: The Case of Cambodia[53]

The tourism sector has been playing a pivotal role in driving Cambodia's growth and employment. However, there are many structural challenges confronting this growing sector—exacerbated by the protracted pandemic, which need to be addressed if the country were to reap the full potential of the sector. This Selected Issue aims to discuss recent developments of Cambodia's tourism sector with cross-country comparison, identify structural issues facing the sector, and delves into policy discussions.

Heady Days Prior to the Pandemic

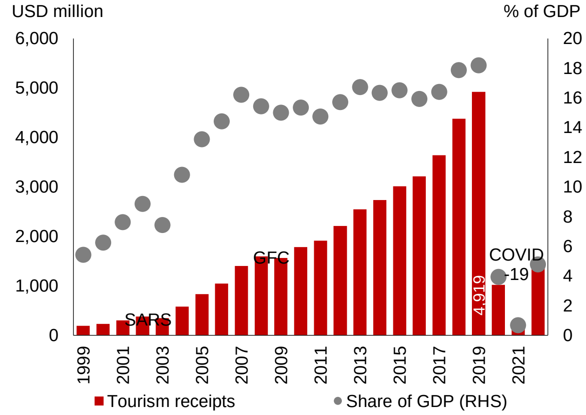
1. **Cambodia's tourism sector had proceeded apace in the run-up to the pandemic.** 2019 marked the best year of the country's tourism sector development, where the number of international tourist arrivals peaked at 6.6 million, alongside the highest tourism receipts of all time—reaching USD4.9 billion, or 18.2 percent of GDP (Figures A4.1 and A4.2). Consistently, the number of guesthouses and hotels also picked up by 16.9 percent and 24.1 percent, respectively, in 2019. Considering direct and indirect impacts, the total contribution of Cambodia's tourism sector amounted to 31.4 percent of GDP and 31.2 percent of total employment, respectively, in 2019, the highest in the ASEAN+3 region (Figures A4.3 and A4.4), according to the World Travel & Tourism Council.

Figure A4.1. Cambodia: Tourist Arrivals



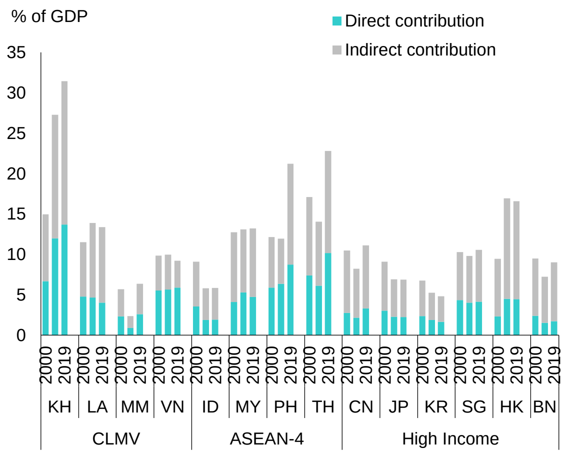
Source: Ministry of Tourism (MOT)

Figure A4.2. Cambodia: Tourism Receipts



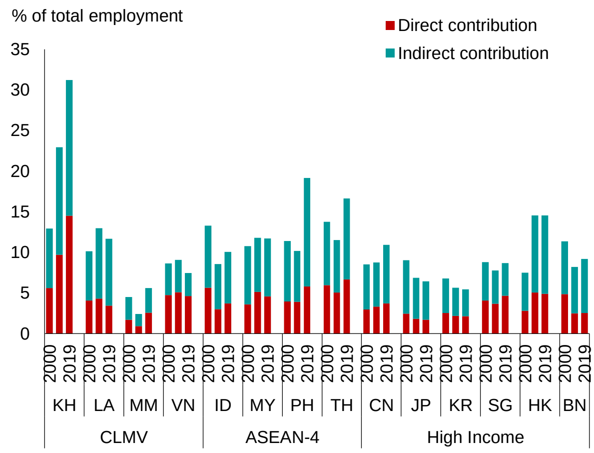
Source: MOT; AMRO staff calculations

Figure A4.3. ASEAN+3: Tourism Sector's Contribution to GDP



Source: World Travel & Tourism Council (WTTC)

Figure A4.4. ASEAN+3: Tourism Sector's Employment



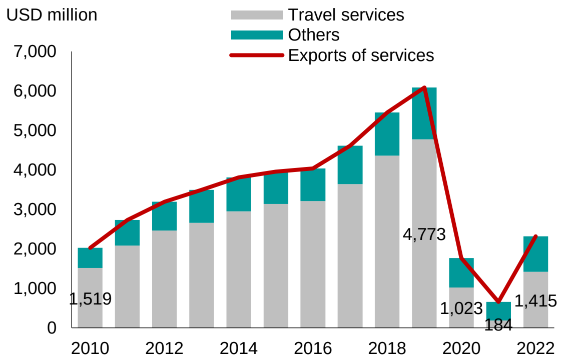
Source: WTTC

[53] Prepared by Vanne Khut, Economist.

The Aftermath of the COVID-19 Pandemic

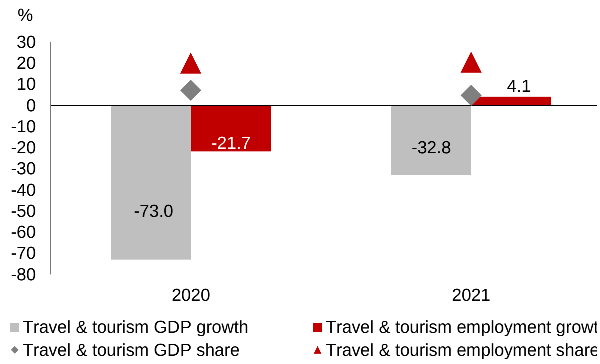
2. The COVID-19 pandemic has disrupted Cambodia's tourism industry on an unprecedented scale. In 2020 and 2021, the number of tourist arrivals and earnings registered a sharp contraction of roughly 82.6 percent and 80.6 percent on average, respectively. This was mainly caused by the restricted mobility in countries around the world, including those in the ASEAN+3 region—which have been Cambodia's top source markets (Figure A4.1). The continued decline in tourism earnings has eroded Cambodia's external position. Travel services exports saw a sharp drop by 78.6 percent to just USD1 billion in 2020 and fell further by 82.0 percent to just USD184 million in 2021, contributing to the widening of the trade deficit to 25.2 percent of GDP in 2021 (Figures A4.5).

Figure A4.5. Cambodia: Exports of Services



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

Figure A4.6. Travel and Tourism GDP and Employment



Source: WTTC

3. The protracted COVID-19 pandemic has also taken a great toll on Cambodia's growth, employment, and poverty alleviation efforts. Cambodia had reaped large benefits from the travel and tourism sector prior to the pandemic (Figures A4.3 and A4.4). However, the sector's contribution to GDP shrank sharply to just 7.2 percent in 2020 and 4.7 percent in 2021 (Figure A4.6). The collapse in the travel and tourism sector also led to high job losses, where employment declined by 21.7 percent in 2020 (Figure A4.6). This contributed to the dampening of Cambodia's private consumption, which slipped into contraction of 4.3 percent in the same period, as well as the reversed progress of poverty reduction, with the poverty rate estimated to have increased by 2.8 percentage points in 2020 (The World Bank, 2022).

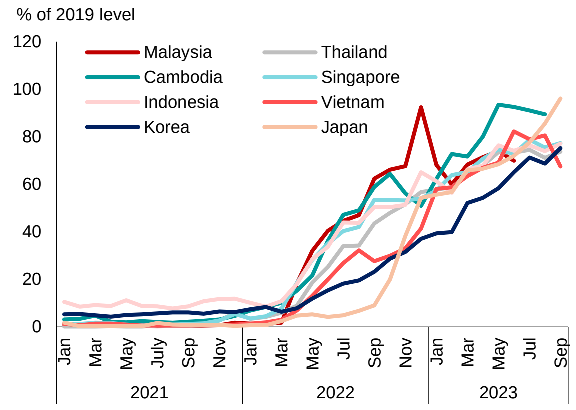
The New Normal Post Pandemic: Recovery Hindered by Persistent Structural Challenges

4. Cambodia's first-mover advantage is outmatched when tourism powerhouses in the region have subsequently reopened. Cambodia was the first country in Asia to fully reopen its economy and welcome international visitors, starting 15 November 2021.[54] Although staging a significant rebound since the full reopening, the number of foreign visitors to Cambodia has yet to reach the pre-pandemic level, while visitors to other countries in the region reopening much later are picking up the pace (Figure A4.7). The number of arrivals to Cambodia rose to 2.3 million in 2022 from a low base of 196.5 thousand in the previous year and continued to edge up further in the first eight months of 2023—reaching around 80.3 percent of 2019 level (Figure A4.7).[55] Even after China's reopening since 15 March 2023, the

[54] Source: WIT
[55] Tourism receipts, meanwhile, saw a significant improvement to USD1.4 billion in 2022 from USD184 million but remained lower than pre-pandemic levels.

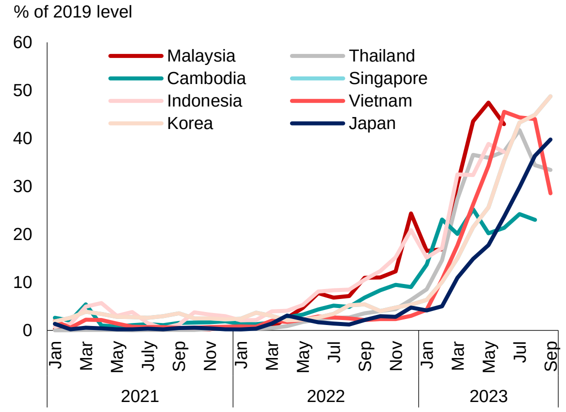
number of Chinese visitors—who used to top Cambodia's arrival market for several consecutive years in the run up to the pandemic—continue to be very low (Figure A4.8).

Figure A4.7. Select ASEAN+3 Countries: Monthly Tourist Arrivals



Source: National authorities; AMRO staff calculations

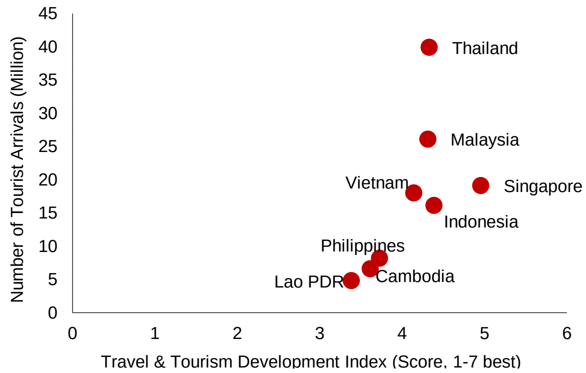
Figure A4.8. Chinese Tourists to Select ASEAN+3 Destinations



Source: National authorities; AMRO staff calculations

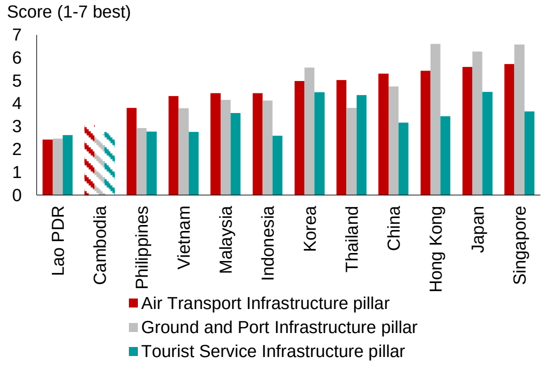
5. Existing structural challenges in the tourism sector have disadvantaged Cambodia, notwithstanding its early economic reopening. Scoring 3.6 out of 7, Cambodia ranks poorly, 79th out of 117 economies, in the latest Travel and Tourism Development Index (TTDI),[56] lagging behind most of its regional peers which attract higher number of foreign visitors (Figure A4.9). Limited infrastructure, ranging from air connectivity to tourism facilities, is one of major bottlenecks holding back the development of Cambodia's tourism sector. Cambodia underperforms regionally in terms of infrastructure development, scoring very low in all pillars of the infrastructure subindex (Figure A4.10). In terms of air connectivity, for instance, there are very few airlines serving the country, and insufficient long-haul and direct flights (Figure A4.11). Cambodia's long-standing issue with respect to the inadequacy of skilled labor also contributes to the underdevelopment of the tourism sector. Latest data suggest that Cambodia is outperformed by other regional economies when it comes to human resources and labor market conditions (Figure A4.12).

Figure A4.9. Select ASEAN Economies: Travel and Tourism Development Index (TTDI) and Number of Tourist Arrivals



Source: World Economic Forum (WEF); National authorities
Note: The latest TTDI is 2021. To avoid distortion, the data point used for the number of arrivals is 2019.

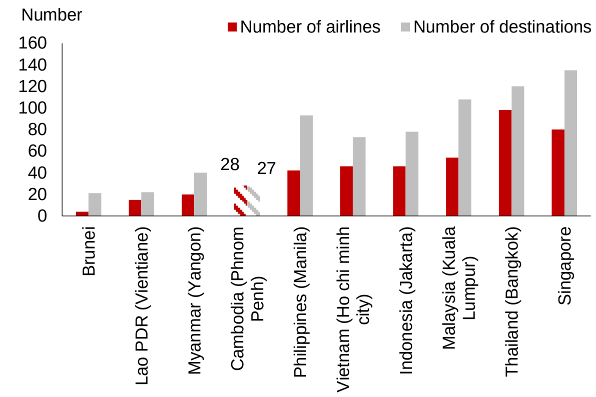
Figure A4.10. Select ASEAN+3 Economies: Infrastructure Subindex by Type under TTDI



Source: WEF

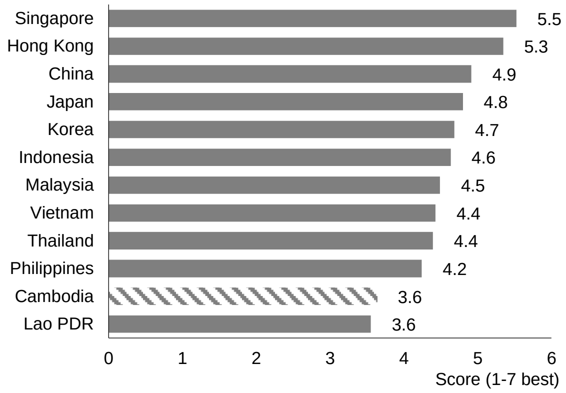
[56] The 2021 TTDI is comprised of five subindices, such as enabling environment; travel and tourism policy and enabling conditions; infrastructure; travel and tourism demand drivers; and travel and tourism sustainability.

Figure A4.11. ASEAN: Number of Airlines and Destinations



Source: FlightsFrom.com

Figure A4.12. Select ASEAN+3 Economies: Human Resources and Labor Market Pillar under TTDI



Source: WEF

6. Undiversified tourism products and limited investment in tourism-related industries continue to weigh on the development of the sector. The variety of tourism products in Cambodia remains limited, with a high concentration on cultural heritage, especially surrounding the Angkor Wat, the world's largest religious structure.[57] Besides, adjacent to the tourist attractions, there are very few other tourist attractions, such as theme parks, as well as limited number of shopping centres. Moreover, the locally manufactured products/ souvenirs appear to be scarce in the market, which could be due to Cambodia's weak supporting industries, resulting in large imports of products to meet the tourism industry's demand (See Box A2). Moreover, the availability of international hotel brands in Cambodia is quite limited relative to other tourism powerhouses in the region, suggesting there is still room to invest in hotels with better facilities.[58] This makes Cambodia less attractive compared to neighbouring countries—leading to shorter stay and lower spending. Generally, tourists spend around six days in Cambodia, shorter than their stay in neighbouring countries, while spending per tourist is also relatively low (Figures A4.13 and A4.14). Anecdotal evidence suggests that tourists from the US and EU—who are generally perceived to be high-end tourists—do not view Cambodia as a key tourist destination but rather an add-on when they are on trips to nearby countries, thereby resulting in shorter stays in Cambodia of just a few days.

7. Insufficient tourism promotion and over-concentration on cultural/ historical heritage limit the country's international recognition and undermine its attractiveness. While having overly focused on the Angkor Wat, Cambodia's tourism marketing campaigns have so far been quite limited and not in line with international standards (Ministry of Tourism, 2021), reflecting local authorities' limited capacity and inadequate investment or budget constraint. Between 2021 and 2023, Cambodia has planned around USD10-13 million for tourism promotions (Table A4.1), up from USD3.5 million in 2014.[59] Nevertheless, this amount is still much smaller than Thailand's budget for tourism promotion measures—tabled at THB1.93 billion (USD55 million) in 2023, of which 26.8 percent are for overseas marketing and 23.1 percent to the production of merchandise or the organization of activities to promote the tourism sector.[60]

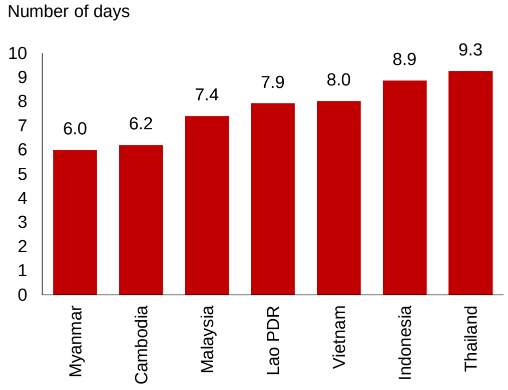
[57] Angkor Wat is the world's largest religious structure, enclosing 162.6 hectares (Source: Guinness World Records).
[58] These include Sofitel Hotel & Resorts, Rosewood Hotels & Resorts, Park Hyatt, Raffles Hotels & Resorts, Six Senses, Hotel Emion, Ibis Hotels, Courtyard by Marriott, Alila Hotels & Resorts, Belmond, and Le Meridien (Source: Khmer Times).
[59] Source: The Phnom Penh Post
[60] Source: The Nation; AMRO staff calculations

Table A4.1. Cambodia: Planned Budget for Select Tourism Promotion Projects

Selected Projects	Planned Budget	Year	Budget Source
Visit Cambodia 2022-2023	USD6-8 million	2022-23	State & private sector
Strengthening the promotion of domestic tourism information and the establishment of Tourist Information Centers at Provinces-Cities	USD4-5 million	2022-23	State & private sector
Establishment of Cambodia Pass	USD0.3 million	2020-21	State & private sector
Clean Up Cambodia Campaign: To Welcome SEA Game-2023 Event	USD0.1 million	2021-23	State & development partners

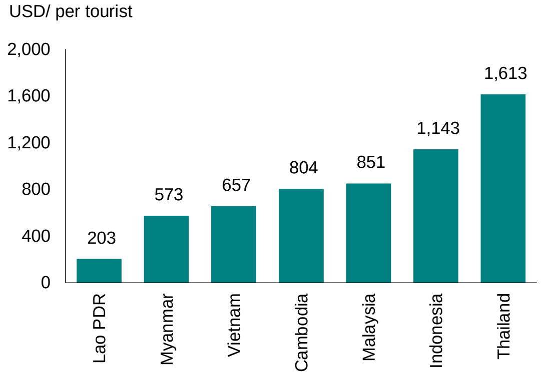
Source: Roadmap for Recovery of Cambodia Tourism During Post COVID-19

Figure A4.13. Select ASEAN Economies: Length of Stay (2019)



Source: National authorities; Statista

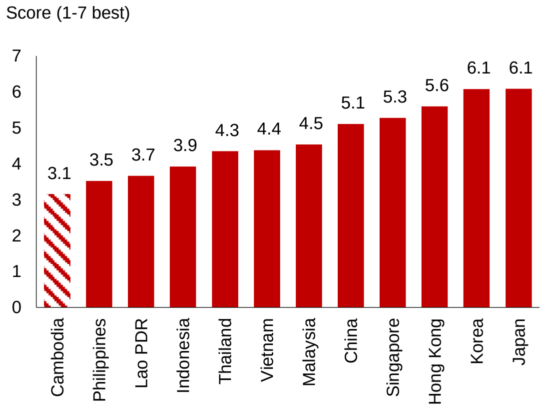
Figure A4.14. Select ASEAN Economies: Tourism Receipts Per Tourist (2019)



Source: National authorities; AMRO staff calculations

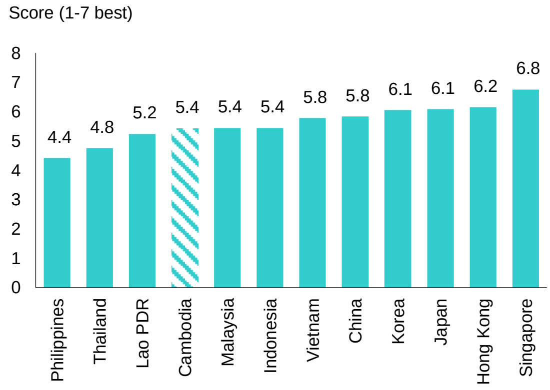
8. **The lack of hygiene due to poor waste management, and safety and security issues somewhat influence the decision of foreign tourists to Cambodia.** Irrespective of the destination, visitors attach great importance to hygiene and quality of accommodation, food, as well as the surrounding environment. Cambodia, especially in the capital and at key tourist attractions, has long had hygiene and waste management issues.[61] When compared to other regional economies, Cambodia is the worst performer in health and hygiene—scoring just 3.1 (Figure A4.15). Safety and security are also key to ensuring tourism's quality and determining the failure or success of any tourist destinations, including Cambodia whose performance in the areas is relatively poor (Figure A4.16).

Figure A4.15. Select ASEAN+3 Economies: Health and Hygiene Pillar under TTDI



Source: WEF

Figure A4.16. Select ASEAN+3 Economies: Safety and Security Pillar under TTDI



Source: WEF

[61] In Phnom Penh, roughly 35.7 percent of urban poorer communities do not have access to garbage collection services (Sahmakum Teang Tnaut 2019). According to WHO/UNICEF Joint Monitoring Programme (JMP), 31 percent of Cambodia's households lack basic sanitation facilities, while 72 percent of households lack access to a safely managed water supply (Source: Planet Water).

Policy Implications

9. The government has released various support measures to mitigate the impact of COVID-19 on tourism businesses and individuals, ranging from fiscal to financial policies. On the fiscal front, at least 10 rounds of intervention measures have been undertaken. These include tax exemptions for businesses in tourism and aviation sectors; wage subsidy for workers in the tourism industry; exemption from renewal fees for all types of tourism licenses; among others (AMRO, 2022). Launched in May 2022, the Tourism Recovery Co-Financing Scheme (TRCS)[62]—worth USD150 million, of which 50 percent is from the government—has been playing an important role in reviving tourism businesses hard hit by the pandemic. As of August 2023, only USD54.2 million had been disbursed to affected tourism businesses—accounting for 36.1 percent of total package, mostly in the Siem Reap province, Phnom Penh, and Sihanoukville. Moreover, the government has also spent around USD150 million to renovate 38 urban roads in the Siem Reap province—part of the 2021-2035 Siem Reap Master Plan, aimed at attracting 7.5 million foreign tourists to the city while generating 940,000 jobs and an additional USD6 billion in revenue by 2035.[63]

10. The underdevelopment of Cambodia's tourism industry underscores the need to expedite the diversification of tourism products and promotional themes. Cultural/historical attractions, specifically the Angkor Wat, alone cannot serve as major pull factors for tourists to visit the country. Endowed with diverse tourism assets,[64] Cambodia should take the opportunity to further diversify its tourism industry by increasingly putting focus on community-based tourism (CBT) and ecotourism while building necessary support infrastructure. These can generate higher value-add for the economy and ensure stable income stream for local communities.[65] Currently, Cambodia has 146 ecotourism operations, of which 87 are community-based ecotourism (CBET) and 59 private ecotourism operations (The World Bank, 2020).[66] [67] The development of CBT and ecotourism in Cambodia, nonetheless, remains a big challenge due to several bottlenecks, e.g., limited government investment, insufficient relevant policy and regulatory frameworks, poor connectivity infrastructure, among others. Tonle Sap Lake, for instance, is a potential ecotourism site to attract foreign visitors, yet the transport infrastructure remains weak with a low quality of boats operated by locals (Ministry of Tourism, 2021).

11. The diversification of source tourist markets is also important to cushion the industry against external shocks. A year prior to the pandemic, China and ASEAN countries topped Cambodia's tourism market, making up nearly 70 percent of total arrivals. In response to the pandemic, countries across the world had imposed travel restrictions for years to combat the COVID-19 infections. As a result, Cambodia's tourism industry had suffered a great ordeal given the overreliance on specific countries, especially China whose border has been fully reopened only since March 2023. In this regard, the diversification of tourism markets is

[62] Businesses can apply for loans up to USD400,000 with a maximum interest rate of 6.5 percent per annum and loan terms up to seven years (Source: Cambodianess). To guarantee co-financing loans disbursed under the TRCS, the Co-Financing Guarantee for Tourism Scheme (CFGS-T) was established in July 2022, mitigating 80-percent credit risk faced by 25 participating financial institutions—such as SME bank, commercial banks, and microfinance institutions (Source: Ministry of Information (July 13, 2022); Credit Guarantee Corporation of Cambodia).
[63] Source: Nikkei Asia; Tourism Development Master Plan Siem Reap (2021-2035)
[64] Rich in natural resources and biodiversity, Cambodia comprises 57 protected areas extending over an area of 7,439 hectares, in which there are national parks, wildlife sanctuaries, protected areas, multi-use areas and Ramsar site. Cambodia is also home to rare species in Asia (e.g., Mekong river dolphins, pink dolphins), marine flora, and sea creatures (Ministry of Tourism, 2021).
[65] CBT and CBET projects allow local communities to be strongly involved in the decision-making process and to benefit from the profits directly, which eventually helps further promote community development (Hsieh, 2016).
[66] As of 2016, there were 66 CBT and CBET projects across Cambodia (Hsieh, 2016).
[67] World Bank (2020) has identified three potential ecotourism destinations in Cambodia, such as Koh Kong province; Siem Reap province (Kulen-Tonle Sap); and Phnom Aural Protected Area.

important to help mitigate adverse effects of shocks on the industry, emanating from the pandemic or geopolitical events, for example.

12. Government's targeted financial support and related investment are crucial to addressing long-standing structural issues in the tourism sector and increasing its value-add. More investment and financial support are needed to improve both hard and soft infrastructure to support all tourism segments, including cultural/ historical, CBT and ecotourism. This includes improving transport infrastructure—e.g., increasing the number of long-haul and direct flights; building more entertainment establishments, theme parks, shopping centers around key tourist attractions; investing more in accommodation with better facilities; upgrading skills of the labor force; engaging more MSMEs in the production of souvenirs; among others. Besides, the authorities are encouraged to conduct tourist satisfaction surveys to collect information/ feedback from tourists on their perception of Cambodia's attractions and related services, and what should be improved to meet their demand. The authorities can leverage digitalization to expand the coverage of the survey on top of physical collection during their stay in Cambodia. Separately, it is commendable that the authorities have placed waste management as one of the priorities on the national agenda as stipulated in the Municipal Solid Waste Management Policy 2020 – 2030. Another encouraging step in the right direction is the authorities' ongoing initiative to establish the Tourism Satellite Account (TSA), which will allow Cambodia to harmonize and reconcile tourism statistics from an economic perspective.[68]

13. Harnessing digitalization to boost tourism development is recommended. At present, Cambodia has yet to be seen as a standalone destination by most travellers, although the country possesses a variety of beautiful beaches, islands, and many other attractive offerings, in addition to its richness in culture and history. In this connection, the country should put greater efforts into the destination promotion side, especially through digital marketing to expand its presence and therefore grow its recognition globally. To build back a better travel and tourism industry in the post pandemic new normal, a wider range of digital advances should be adopted to modernize its immigration system; facilitate visa application; improve ticketing and reservation not only for travel and accommodation but also for other services; among others. Digital innovation will help make the entire immigration process more time and cost efficient for both visitors and authorities, especially when it comes to information provision and collection, while ensuring efficient resource management for the authorities. As a matter of fact, Cambodia's immigration processes remain largely paper-based, e.g., immigration and customs declaration forms. Moreover, digital literacy training programs and vocational schools established by the authorities during the pandemic are commendable. These should be maintained and further improved to help digitally upskill Cambodia's tourism workforce.

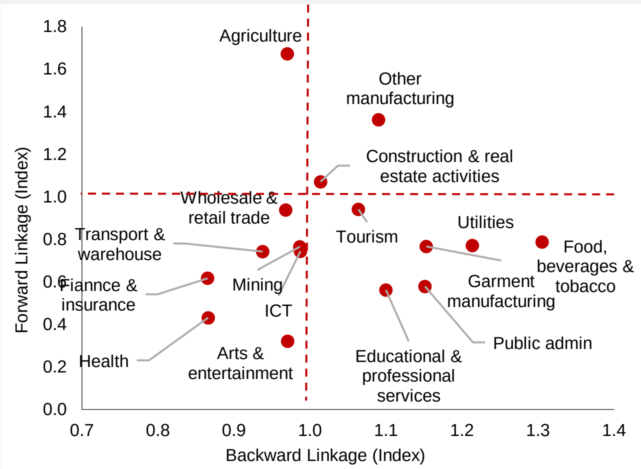
[68] Developed by the World Tourism Organization, the TSA is a standard statistical framework used for the economic measurement of tourism (OECD, 2008).

Box A4.1. Cambodia's Tourism Sector: Weak Sectoral Linkages and Import Leakages

While the tourism sector's contribution to GDP continues to be high, its interconnection with other segments of the economy remains relatively weak. With backward linkage valued at slightly larger than 1, Cambodia's tourism sector appears to have weaker sectoral dependence or linkages with other industries compared to other key sectors, in particular food, utilities, and garment industries (Figure A4.1.1).

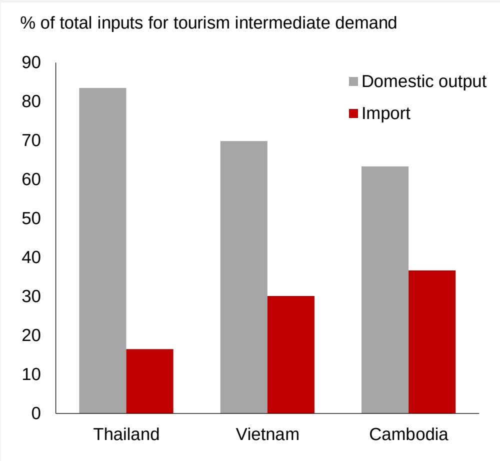
Weak domestic manufacturing continues to cast a shadow on the tourism sector through import leakages. On top of its locally manufactured products, Cambodia has so far imported a variety of products, including souvenirs, for sales at tourist attractions, given insufficient domestic supply. The latest data suggest that Cambodia imports about 36.7 percent of total inputs for its tourism intermediate demand, higher than in neighboring countries, e.g., Thailand and Vietnam which have built robust domestic manufacturing (Figure A4.1.2).

Figure A4.1.1. Cambodia: Inter-Industry Dependence



Source: OECD; AMRO staff calculations
Note: The calculation is based on OECD's Input-Output Tables (IOTs) 2021 ed. The latest data available is 2018. The tourism sector is the sum of accommodation and food services, air transport, and other service activities. The computation includes both first round and second round effects.

Figure A4.1.2. Select Countries: Share of Imports Tourism Intermediate Demand



Source: OECD; AMRO staff calculations
Note: The calculation is based on OECD's IOTs (2021 edition) the latest available data as of 2018. The tourism sector is the s of accommodation and food services, air transport, and other service activities.

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