

Macroeconomic and Banking Sector Development in 2016 and Outlook for 2017

Prepared by the National Bank of Cambodia

In 2016, the global economic growth remains moderate and uneven. Amongst the advanced countries, the U.S. economy experienced slower growth than expected, while the Eurozone's economy is still weak mainly due to the uncertainty from Brexit beside the existing challenges. At the same time, Japan's economy has gradually recovered, supported by monetary and fiscal policy stimulus, but growth remained low. In emerging and developing countries, China's economic growth slowed down further toward a more balanced growth path and is gradually relying more on domestic demand and service sector, whereas the ASEAN-5¹ maintained robust economic growth through accommodative policies to support domestic demand and reduce external vulnerabilities.

Meanwhile, Cambodia continued to achieve satisfactory economic growth at 7% in 2016, driven by strong growth of garment exports, construction and real estate, and tourism, while the agricultural sector has also shown slight improvement. The continued inflow of foreign direct investment (10.7% of GDP), attracted by the positive economic outlook and the amelioration of trade deficit (-7.2% of GDP), contributed to the increase in the overall balance of payment surplus to 5.7% of GDP, compared to 3.7% last year. The surplus also contributed to the accumulation of Cambodia's foreign exchange reserve which now could cover up to 5 months of imports of goods and services. Inflation remained low at around 2.9%, caused by the increases in the price of food, restaurant and cloth groups as a result of the rising domestic demand in line with the improvement of living standard. This is also partially due to low oil price environment in combination with the supportive fiscal and monetary policies. Broad money (M2) grew at the rate of 21%, similar to the average rate within the last 5 years. Meanwhile, this increase continued to lift financial deepening indicator (M2 to GDP) from 67% in 2015 to 74% this year. However, this growth has not caused any inflationary pressure, since credit growth in the banking sector has declined possibly due to the increase of liquidity of banks and financial institutions in compliance with the new Prakas on Liquidity Coverage Ratio (LCR).

However, as the economy and financial system become more developed and interconnected, while dollarization remains high (foreign currency deposit to M2 equals 83%) making implementation of monetary policy ineffective, especially in the case where economy is hit by a shock. In this regard, the National Bank of Cambodia has been proactive in promoting the use of Riel by introducing appropriate measures and policies such as increasing the awareness of the public about the importance of the use of local currency, reducing the transaction costs of payments in Riel, developing instruments and operations of liquidity provision in Riel, and requiring banking and financial institutions to provide loans in Riel on a gradual basis.

The Cambodia's banking system continued to grow robustly and contributed to sustainable and inclusive economic growth in tandem with the government policies. The banking sector's assets increased to KHR 112.6 trillion (around USD 27.8 billion, an increase of 17.4%), while credit and deposit increased to KHR 71.2 trillion (around USD 17.6 billion, an increase of 18.3%) and KHR 62.4 trillion (around USD 15.4 billion, an increase of 20.7%). At the same time, the banking system remains healthy, reflected by high level of liquidity ratio of banks and microfinance institutions (128% and 152%, respectively), high level of solvency ratio (22.4% and 21%, respectively), and low ratio of non-performing loan (3.5% and 1%, respectively). It is worth noting that the Cambodia's

¹ According to the IMF, ASEAN-5 includes: Indonesia, Malaysia, Thailand, the Philippines, and Vietnam.

Financial Intelligence Unit has also strengthened its capacity to monitor and evaluate financial transactions and prevent money laundering and terrorism financing activities.

Given highly competitive market of banking sector in Cambodia, lending rate has fallen consecutively benchmarked by banks' average lending rate in US dollar dropping from 17% in 2005 to 11.8% in 2016 and by microfinance institutions' from around 40% to 28% for the same period. Nevertheless, these lending rates remain high, particularly amongst microfinance institutions. Interest rate determined and set based on risks that the lending institutions are facing, costs of capital, and costs of operations. Microfinance institutions in Cambodia mostly obtain financing from domestic and oversea investors with high interest rates coupled with their high costs of operations, especially for small loans in the rural areas; therefore, they have to charge high interest rates as well. So far, to reduce lending rate, the National Bank of Cambodia has continued to promote and ensure equal and transparent competition, as well as to encourage microfinance institutions to reduce their lending rate over time. In 2016, the National Bank of Cambodia introduced Liquidity Providing Collateralized Operation (LPCO) which allows banks and financial institutions that need Riel liquidity for their operations to obtain it at reasonable cost. With this operation, the National Bank of Cambodia would also be able to influence the market interest rate and lower the interest rate in the future. On the other hand, efforts in introducing these new measures also require participation of banks and microfinance institutions, for example, in providing financial services and products that meet demand and repayment capacity of borrowers. In this regard, the implementation of the MoU on Loan-Providing Guidance signed this year in Sihanouk province reflected the commitment of Cambodia Microfinance Association (CMA) in avoiding over-indebtedness of borrowers, reducing credit risk, and lowering interest rate through improving quality and completeness of credit information given to Credit Bureau of Cambodia, deepening the study on clients' repayment capacity, encouraging fair and ethical competition, and promoting customer protection.

It should be highlighted that despite challenges, the microfinance sector in Cambodia has been recognized by national and international communities as a key player in promoting financial inclusion and in constantly contributing to poverty reduction in Cambodia. In 2016, the National Bank of Cambodia organized a national summit on the Development of Microfinance Sector in Cambodia, presided over by Samdach Akka Moha Sena Padei Techo HUN SEN, Prime Minister of the Kingdom of Cambodia. This summit was to commemorate the remarkable development of the microfinance sector during the last 10 years and also to enhance public awareness on the role of microfinance in contributing to economic development and poverty reduction in Cambodia. Besides, the World Bank's Doing Business 2017 report released this late year ranked Cambodia number 7 in the world for the ease of obtaining credit.

To further promote financial inclusion and reduce transaction costs, the National Bank of Cambodia has introduced new technology to improve efficiency and reduce costs in payment transactions. FAST payment system was launched to promote the use of Riel and also to allow for an immediate receipt of fund transfer between two bank accounts. In 2017, the National Bank of Cambodia is going to launch the Central Shared Switch System which would enable bank customers to use their debit cards to withdraw cash and settle their purchase transactions through any banks' ATMs or POS machines across the country. This will also allow mobile payments and online shopping being processed in a more convenient, more efficient and safer way. In addition, the National Bank of Cambodia will continue and expand "Let's Talk Money" campaign, especially from primary to high school students. This campaign aimed at providing people with better understanding on the management of their families' finance, lending and borrowing in a responsible manner to ensure sustainable financial inclusion.

While financial inclusion has been promoted, the National Bank of Cambodia has paid close attention to strengthening financial stability, particularly in current situation where credit is still growing rapidly while the global financial market conditions remained uncertain. It is worth mentioning that during the last decade, credit to private sector has increased rapidly and overtaken those in the region. Nevertheless, its trend has gradually slowed down. Credit growth was 75% in 2007, declined to 31% in 2014 and to 23% in 2016. The credit growth mainly resulted from: i/- the rapid development of economic activities, the increase in people's income (from USD 628 to USD 1,300 per capita), and positive outlook of Cambodia's economy (growth averages around 7% and is expected to stay at this rate in the medium term), ii/- the increase in deposit (from 27% to 71% of GDP) and the increase in inflows of foreign investments and borrowings in the banking sector (increase from 3.3% to 5.9% of GDP), iii/- the increase in credit originating from a low base (credit to GDP was 20% in 2007 and is currently 86%), iv/- the increase in adult population and demand for financial services (financial inclusion rate elevated threefold to 54% of the adult population in 2016) and v/- the lack of financial instruments in Cambodian financial markets. To maintain financial stability, macro-prudential measures have been carefully studied and implemented on banks and microfinance institutions to gradually reduce credit growth. In 2016, the National Bank of Cambodia strengthened its regulation on Liquidity Coverage Ratio in line with Basel III principle and increased the minimum registered capital for banks and microfinance institutions, among other existing measures. These measures coupled with the market conditions have reduced credit growth gradually (soft landing), and 2017 credit growth rate is expected to slow to 21%. These conditions have urged banks and microfinance institutions to diversify their sources of income beyond interest income in order to ensure the sustainability of their businesses.

Looking forward, global economic growth in 2017 is projected to be higher than that in 2016, reaching 3.4% despite uncertainty and risks. Growth in advanced economies, emerging and developing countries, and ASEAN-5 countries are expected to increase to 1.8%, 4.6% and 5.1% respectively. Since Cambodia is a small and open economy, which highly integrated into the region and the world, its economy will benefit from the recovery of global economy and robustness of economic growth in the region amid the increasing exposure to external risks. Based on the projection by major international financial institutions such as the International Monetary Fund, World Bank and Asian Development Bank, as well as the Cambodian government, Cambodian economy continues to move forward on its long-term growth path at around 7% in 2017, supported by strong garment sector, the growth in construction and real estate sector, as well as the rebound in tourism and agriculture sectors. The expansion of economic activities will be buoyant by: i/- continuous comprehensive structural reforms in all sectors ii/- Cambodia's economic potentials as a member of the ASEAN Economic Community (AEC), in which Cambodian market is able to receive more inflows of capital and investment and expand its intra-regional trade iii/- its strategic location which ease the connection by both land and maritime transportation along the One Belt-One Road initiative (OBOR) which would allow Cambodia to increase its investment and trade with China and other countries along the One Belt-One Road, iv/- continuous tax exemptions on exports from Cambodia to Europe under the "Everything But Arms" regime and to U.S with the tax exemptions on exports of travelling goods, and v/- demographic dividend as about 65% of total population are under 35 years old. Inflation is expected to slightly increase to around 3%, a bit higher than that in 2016 due to expectation of oil price increase and increased imported inflation from the neighboring countries, while the exchange rate is expected to be stable around 4,050 Riel per USD. Money supply (M2) will increase approximately 19%, supported by the growth of credit to private sector and the surplus of balance of payments.

However, growth potentials also face some downside risks such as: i/- negative impact of US dollar appreciation on Cambodia's exports and tourism, as the economy is highly dollarized ii/-market expectation on the tightening of the global financial liquidity which could reduce capital inflows into the region and have spill-over effects on Cambodia through the reduction in investment inflows and the upward pressure on interest rates in Cambodia after the Federal Open Market Committee (FOMC) of the U.S Federal Reserve decided to increase the policy interest rate by 0.25% to 0.75% on December 14, 2016, iii/- increase in export competition from other countries in the region, and iv/- the rising trend of trade protectionism in developed countries which would have negative implication on Cambodia's exports. For the risks that stem from domestic factors, Cambodia's economic growth could be affected by the slower growth in the real estate and construction sector, high credit growth to these sectors, and decline in price competitiveness due to the increase in the employees' minimum wages in garment sector. At the same time, Cambodia continues to face major structural impediments such as: high dollarization, high energy price and transportation cost, insufficient physical infrastructures, and lack of skilled labor.

To further support sustainable economic growth in line with the government's policies, the National Bank of Cambodia will continue to implement prudent monetary policy to maintain price and exchange rate stability, aiming at contributing to macroeconomic stability. In this regard, promoting the use of local currency is still one of the prioritized policies to improve effectiveness of monetary policy. Interbank market is further developed by encouraging the use of Negotiable Certificate of Deposits (NCDs) and Liquidity Providing Collateralized Operation (LPCO) while Online Trading Platform will also be put in place to ameliorate the efficiency of trading and auction. At the same time, foreign exchange market is to be developed into a wholesale market where effective oversight is to be applied. Other market-based monetary policy instruments are being studied and expect to be introduced in the future. Moreover, the National Bank of Cambodia would continue to strengthen banking sector and develop relevant financial infrastructures in order to achieve a sound, efficient, diversified and inclusive market-based financial system that can broadly fulfill domestic demand for financial services and are able to maintain financial stability and effectively support sustainable economic growth, raise people's income, reduce poverty and well align with regional economic and financial integration in line with the Financial Sector Development Strategy 2016-2025. Based on these objectives, the National Bank of Cambodia will continue to ensure the effective implementation of all designated strategies and action plans by cooperating with relevant local and international institutions. The supervisory capacity and regulatory frameworks in the banking sector are being strengthened in accordance with international standards and best practices, particularly Basel Principles. To mitigate credit risk and increase transparency, the quality and scope of credit information sharing system has been gradually enhanced and expanded while payment system development strategy, financial inclusion strategy, customer protection, and financial literacy strategy are being formulated to ensure sustainable, robust and inclusive banking sector development. Furthermore, data quality related to the banking sector, monetary sector, and balance of payments will be further improved to be more reliable and timely. Research capacity, skills on macroeconomic and financial analysis, and macroeconomic forecasting will continue to be enhanced for better policy decision making, especially based on evidence and comprehensive analysis.

Lastly, the National Bank of Cambodia will continue to promote regional and international cooperation, especially to strengthen regional financial safety net under the Chiang Mai Initiative Multilateralization (CMIM) as well as to exchange information and experience and seek technical assistances from other central banks, authorities and other development partners in both bilateral and multilateral frameworks.