

Cambodia Economic Update



Improving Macroeconomic and Financial Resilience

Selected Issue

Recent Developments of the Financial Sector: Opportunities and Risks



WORLD BANK GROUP

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Improving Macroeconomic and Financial Resilience

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Preface and Acknowledgements

The Cambodia Economic Update (CEU) is a product of the staff of the World Bank. It was prepared by Sodeth Ly and incorporates contributions by Miguel Eduardo Sánchez Martín, both at the Macroeconomics and Fiscal Management Global Practice (MFM GP). Linna Ky served as research assistant. The team worked under the guidance of Mathew A. Verghis, Practice Manager, MFM GP. Ratchada Anantavasilpa and Colleen Mascenik, Finance and Markets (FAM) GP contributed the selected issue on Recent Developments of the Financial Sector: Opportunities and Risks, which was reviewed by James Seward, Practice Manager, FAM GP. The team is grateful for the comments, advice and guidance provided by Ulrich Zachau, Country Director, and Shabih Ali Mohib, Program Leader.

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For information about the World Bank and its activities in Cambodia, please visit our website at www.worldbank.org/cambodia.

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A. Executive Summary

While remaining robust, growth in 2015 eased slightly to 7.0 percent, slightly below the 7.1 percent achieved in 2014. The performance of the garment sector improved in 2015, while signs of economic moderation and weakness persisted in the tourism and agriculture sectors, respectively. Cambodia's real growth is projected to remain healthy at 6.9 percent in 2016, driven partly by a significant increase in government spending. Strong garment exports should help to offset a slowdown in agriculture, while the construction sector is expected to continue to remain an engine of growth. Downside risks to this outlook include potential renewed labor issues, continued appreciation of the US dollar, slower economic recovery in Europe, and spillovers from a slowdown in the Chinese economy. The downward trend in poverty is expected to continue over the next few years, albeit at a slower pace, given the context of sluggish agriculture growth.

Recent developments

Cambodia's export-led growth gained momentum after the second quarter of last year and real growth is estimated to have reached 7.0 percent in 2015. Following a slowdown in early 2015, garment exports—one of the main drivers of growth—rebounded in the second half of the year, ending at a nominal year-on-year growth rate of 12.3 percent, compared with 9.2 percent in 2014. Having relatively good labor market stability coupled with gradually moving up the value chain appear to have helped the sector expand. In 2015, the construction sector continued to expand, driven by sustained foreign direct investment (FDI) into the sector, although approvals decelerated. Total tourist arrivals in 2015 grew by 6.1 percent (reaching 4.78 million visitors), compared with 6.9 percent in 2014, despite recovering tourism activity in Thailand and neighboring countries. Rice production in 2015 is estimated by the authorities to have been lower than in 2014, partly caused by drought; sluggish improvements in yields and depressed agriculture

commodity prices constrained also growth in the agriculture sector.

Rising exports and falling oil prices underpin an improved external position. The current account deficit narrowed to 10.8 percent of GDP in 2015, compared with 11.9 percent in 2014. The deficit was financed by continued strong FDI inflows, estimated to have reached US\$1.8 billion (or 10 percent of GDP) in 2015. The resilient external performance resulted in rapidly rising gross international reserves, which reached US\$5.6 billion (or 4.4 months of imports) by end-2015, compared with US\$4.6 billion in 2014.

Continuing rapid expansion of the financial sector has accommodated economic growth, and inflation picked up in late 2015. Domestic credit growth accelerated further, to 27 percent year-on-year in 2015, spurred on by rising domestic demand for consumption and construction. Meanwhile, private sector deposits growth halved to 16.6 percent year-on-year in 2015. As a result, the loan-to-deposit ratio rose to 95.6 percent. Growing internal demand has also pushed up inflation, which reached 2.3 percent year-on-year in February 2016. The Cambodian riel (CR) appreciated slightly, reaching CR 4,008 per US dollar in February 2016, compared with CR 4,075 per US dollar in December 2014. Appreciation of the riel against the Thai baht and the Vietnamese dong also continued, while the real effective exchange rate (REER) appreciated further.

Fiscal performance has improved, with substantial revenue growth and contained expenditures continuing to curb the overall fiscal deficit. Tax revenue increased from around 10 percent of GDP in 2010 to 15.1 percent in 2015, thanks to improved administration and strong economic growth. Total domestic collection reached an estimated 17.5 percent of GDP in 2015, while spending is expected to have remained contained at 20.5 percent of GDP, despite increasing wage pressures. The overall

government deficit including grants narrowed to 0.8 percent of GDP in 2015, compared with 1.4 percent in 2014, despite a decreasing grant component. Cambodia's debt distress rating in the latest World Bank/IMF Debt Sustainability Analysis remained low.

Outlook

Growth is expected to reach 6.9 percent in 2016, partly underpinned by a significant increase in government spending. Strong garment sector exports are expected to help to offset weakness in the agriculture sector, while the foreign direct investment-driven construction is expected to continue to be a major engine of growth. Robust export growth will also support a narrower current account deficit. The central bank's directive (Prakas) issued in March 2016 doubling banks' capital requirements is expected to help strengthen the rapidly expanding banking sector. The 2016 budget reflects expansionary fiscal policy, with spending increasing by 3.6 percent of GDP, of which 1.4 percent is due to rising wages and the rest to capital expenditure and non-wage spending.

Further reduction of poverty is expected for both urban and rural households throughout 2015-2016. For urban households this is explained by the economic sectors in which they participate (mainly construction and services). For rural households there has been an increase in sources of income different to agricultural self-employment income.

In the medium term, growth is expected to remain between 6 and 7 percent, in a context of increasing external competition. Given the narrow production and export base and garment exports (about 70 percent of total) heavily concentrated in the EU and US markets, the economy is exposed to mounting competition. With the Trans-Pacific Partnership (TPP) and the free trade agreement (FTA) between Vietnam and the EU, there are significant risks of investment

and export diversion away from Cambodia unless key constraints, such as high energy costs, regulatory impediments to doing business, and infrastructure bottlenecks, are successfully addressed.¹ This could gradually constrain growth unless key structural reforms discussed in the key messages section below are proactively addressed.

The rapidly expanding financial sector has been supportive of growth, but poses also some challenges. At 38 percent, credit growth to the construction sector continued to grow fast in 2015. While being relatively shielded from external financial volatility, the economy remains dependent on bank flows in the form of foreign currency deposits. Given the limited room for monetary policy and the impossibility for the National Bank to act as a lender last resort due to high dollarization, as well as the absence of an inter-bank market, continued high domestic credit growth increases the risks to financial stability in Cambodia.

Other downside risks to this outlook include potential labor issues, continued appreciation of the US dollar in a context of dollarization, slower economic recovery in Europe, spillovers from a slowdown in the Chinese economy. A hard landing of the Chinese economy would dampen growth prospects, mainly due to potentially lower Chinese tourist arrivals in the short term and slower FDI inflows in the medium term. While Cambodia is likely to be shielded from financial volatility due to its limited capital markets, bank inflows remain sensitive to public confidence and market perceptions.

Key messages and policy options

Concentration in the US and EU export markets in a setting of erosion in trade preferences requires structural reforms aimed at boosting competitiveness. As abovementioned, the economy is increasingly exposed to greater competition, given the potential negative impacts for Cambodia of the

¹See the full report on Cambodia Investment Climate Assessment (2014) at <http://documents.worldbank.org/curated/en/2014/01/23946799/cambodia-investment-climate-assessment-2014-creating-opportunities-firms-cambodia>

TPP and the FTA between Vietnam and the EU in the medium to long term, as well as the rise of Myanmar. A series of policy options aimed at underpinning external competitiveness include improving the overall business environment, investing in human capital, and addressing infrastructure gaps.

Improving the overall business environment would enhance competitiveness across sectors, underpinning product and market diversification, while also helping firms to be well prepared to take advantage of the single market and production base goal set by the AEC. A better trained and skilled workforce will certainly help, taking advantage of Cambodia's demographic dividend. Addressing the key constraints, namely high energy costs and infrastructure bottlenecks, point to the need to scale up public investment to sustain external competitiveness.

In order to remain competitive, the authorities could also consider progressively increasing budget allocations to productive and competitive investment projects. In the medium term, concessional borrowing may come increasingly from regional sources, such as the newly established Asian Infrastructure Investment Bank (AIIB), as well as from bilateral sources such as Japan and China. Steadily declining development partner-financed public investment will also require a short-term response whereby additional allocations come from the government budget. Careful prioritization of expenditures and continued buoyant revenue collection will help to make this affordable, if increases in the wage bill can be curbed. Meanwhile, it will also be necessary to further strengthen the rules and regulations governing the management of capital investment projects, as envisaged by a public investment management assessment currently under discussion.

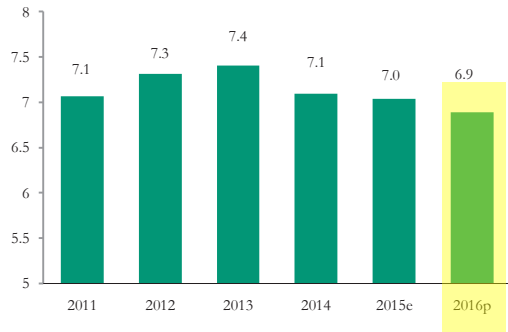
Finally, further enhancing supervision and coordination, regulation, and consumer protection to safeguard financial stability would be advisable, in a moment of fast credit growth. Information deficiencies and a large

'shadow banking' market make it difficult to quantify the risks more precisely. First and foremost, several gaps need to be addressed in terms of data collection and supervision capacity. This includes improving information on non-performing loans, related-party exposures and country-risk exposures, while developing early warning systems in the mid-run. It will also be important to improve inter-agency coordination by deepening the existing collaboration. Second, further strengthening of the regulatory framework is also needed to ensure macro-financial stability. Authorities have introduced some important measures recently, including increasing the capital requirement of financial institutions, the reserve requirement for foreign borrowing, and the liquidity coverage ratio. Finally, fast growth in microfinances would require also from enhancing consumer protection and financial literacy.

THE CAMBODIAN ECONOMY AT A GLANCE

Cambodia's export-led growth continues ...

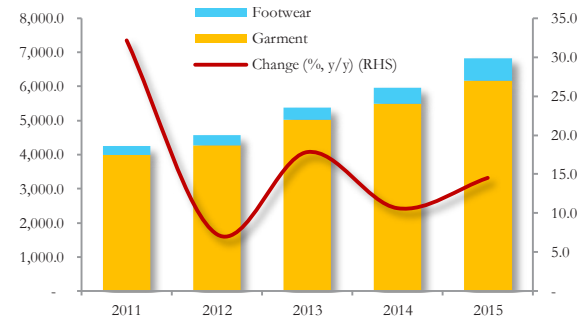
Real GDP growth continues to be robust. (Percent)



Source: The authorities and Bank staff estimates
e = estimate; p = projection

...with rising garment and footwear production...

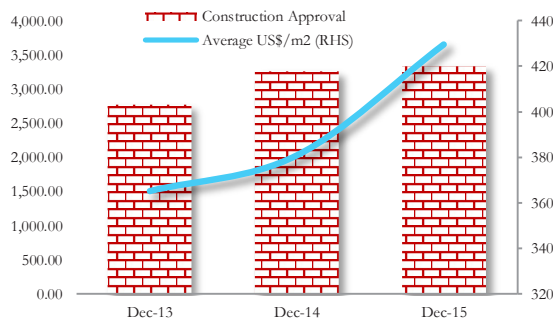
Garment and footwear exports accelerated in 2015 (US\$ million)



Source: The Cambodian authorities

...and deepening of the construction sector...

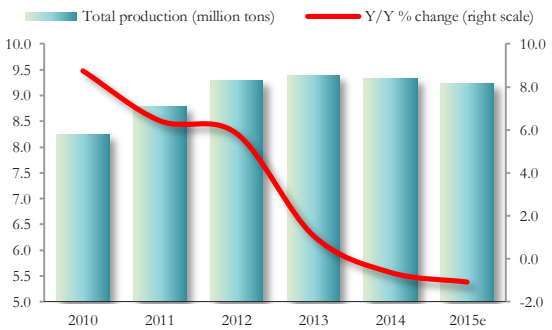
Approved construction projects (US\$ million, YTD)



Source: The Cambodian authorities

... offsetting the decline in agriculture...

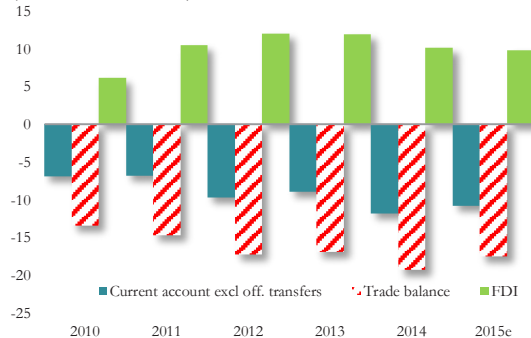
Annual rice production (Metric tons million)



Source: The Cambodian authorities

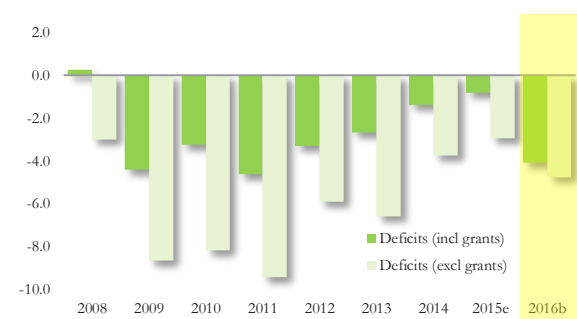
...while healthy FDI inflows finance the external gapand rising collection helps fiscal consolidation.

Trade and current account deficits, and FDI (Percent of GDP)



Source: The Cambodian authorities and Bank staff estimates

General government fiscal deficits. (Percent of GDP)



Source: The Cambodian authorities b= budget

B. Recent Economic Developments

An overview

Cambodia's export-led growth has continued despite US dollar appreciation. Garment exports, one of the main drivers of growth, accelerated at a year-on-year growth rate of 12.3 percent in 2015 in value terms, compared with 9.2 percent in 2014.² Regained labor market stability and the gradual shift towards higher value-added products appear to have helped the sector adjust and expand, despite the appreciation of the US dollar.

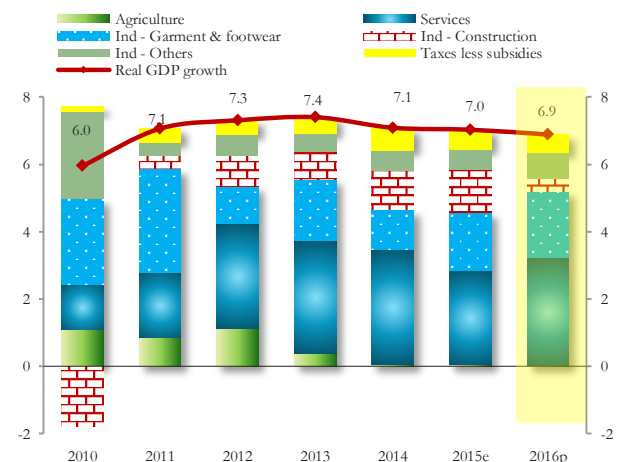
The two main sectors, namely garments (and footwear), and construction (and real estate), are estimated to have provided half of last year's total growth. The garment and footwear sector was the most dynamic, making the largest contribution to growth, at one-third of real growth in 2015, while the construction (and real estate) sector followed, providing about one-sixth of the total. As earlier projected, the tourism sector continued to underperform in 2015, while the agriculture sector stagnated. Growth, therefore, was robust and a revised estimate by the authorities placed it at 7.0 percent in 2015, slightly below the 7.1 percent achieved in 2014 (Figure 1).

Growth is expected to remain robust at 6.9 percent in 2016. Strong garment and footwear performance helps to offset weakness in agricultural production, while construction activity is expected to ease, as the number of project approvals decelerated in 2015. The tourism sector is expected to improve as there has been a recovery in tourism activity in neighboring countries, in particular Thailand, given the dependency of Cambodia's relatively new tourism sector on Thailand's more developed tourism sector.

Downside risks to this outlook include potential renewed labor unrest, continued appreciation of

the US dollar, slower economic recovery in Europe, and spillovers from a slowdown in the Chinese economy. The economy is highly dependent on exports, in particular garment and footwear exports, to two major destinations, the EU and the US. A hard landing of the Chinese economy would dampen growth prospects, mainly due to potentially lower Chinese tourist arrivals in the short term and slower FDI inflows in the medium term.

Figure 1: Garment and footwear sector performance improved, offsetting stagnant agricultural production in 2015. Contribution to annual real growth (In percent)



Source: The authorities and World Bank staff estimates.
e= estimate; p = projection.

Cambodia is likely to be shielded from global financial volatility due to its limited capital markets. Nonetheless, it is worth noting that bank flows in the form of foreign currency deposits remain sensitive to public confidence and market perceptions putting a premium on sound macroeconomic management.

The real sector

a) Garments

Garment production, which goes mainly towards exports and is one of the main drivers of growth, accelerated at a year-on-year growth rate of 12.3 percent in 2015 in value terms, compared with 9.2 percent in 2014 (Figure 2).³ The return of a relatively stable labor

³ Figures based on customs data. Discrepancies may exist with respect to the figures as presented by other government agencies.

market and the gradual shift towards higher value-added products⁴ appear to have helped the sector expand, overcoming challenges on the domestic front despite the appreciation of the US dollar.

While the volume of garment exports continues to drive export growth, the contribution from prices has recently started to pick up (Table 1). Rising volume has continued to drive garment exports growth over the past four years, while the contribution from rising prices improved in 2015, accounting for 28 percent of total garment exports gain in 2015 (Table 1). This seems to indicate that Cambodia is gradually moving into higher value-added products.

Table 1: Volume and price increases contributed 71.9 percent and 28.1 percent, respectively, in 2015.

Increase due to:	2012		2013		2014		2015	
	US\$ mln	(%)	US\$ mln	(%)	US\$ mln	(%)	US\$ mln	(%)
Volume	418.0	149.4	573.5	76.2	561.8	121.3	487.2	71.9
Price	-138.2	-49.4	178.8	23.8	-98.8	-21.3	190.7	28.1
Total	279.9	100.0	752.3	100.0	463.0	100.0	677.9	100.0

Source: The Cambodian authorities.

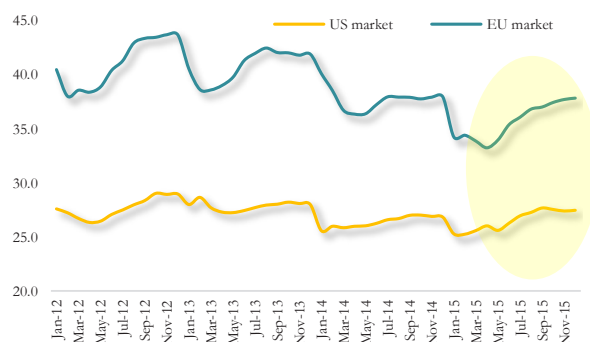
Garment exports to the EU—the largest export market—absorbed 42 percent of total garment exports, and continue to drive Cambodia’s overall garment exports growth.

However, garment exports to the US, accounting for 31 percent of total garment exports, have already peaked. While trending downwards in recent years, prices of garment exports to both the EU and the US markets (Figure 2) held up well in 2015, despite tighter competition in the context of an appreciating US dollar.

Garment exports to the EU were responsible for most of the export gains in 2015, while some destination diversification was also observed. Of the total increase in garment exports value amounting to US\$678 million (or 12.3 percent) in 2015, 60.8 percent, 20.3 percent and 19.1 percent came from increases in exports to the EU, Japan and other destinations outside the US,

respectively (Table 2). The value of garment exports to the US, however, peaked in 2014 and has stagnated since then.

Figure 2: Export prices to the EU and the US edged up in 2015. (US\$ per dozen)



Source: The Cambodian authorities.

Table 2: The value of garment exports to the EU contributed most, at 60.8 percent of the total increase. (In US\$ million)

	2014	2015	Change	% Contribution
Total value	5,489.3	6,167.2	677.9	100
o/w				
EU	2,172.8	2,585.0	412.2	60.8
US	1,889.3	1,888.2	-1.2	-0.2
Japan	326.5	463.9	137.4	20.3
Others	1,100.6	1,230.1	129.5	19.1

Source: The Cambodian authorities.

In volume terms, total garment exports rose by 14 million dozens (or 8.9 percent year-on-year) in 2015. Of this, 78.3 percent, 14.2 percent, and 19.3 percent were contributed by increases in garment exports volumes to the EU, Japan and other destinations (outside the US), respectively (Table 3). In contrast, garment exports volume to

⁴ While the garment sector seems to be shifting towards higher value-added products in 2015, it is necessary to examine detailed exported products and prices to confirm this.

the US market declined, with a negative contribution of 12 percent.

Table 3: Volume of garment exports to the EU contributed most, at 78.3 percent of the total increase in garment exports volume. (Million dozens)

	2014	2015	Change	% Contribution
Total volume	159.1	173.2	14.1	100
o/w				
EU	57.2	68.3	11.1	78.3
US	70.4	68.7	-1.7	-11.9
Japan	5.0	7.0	2.0	14.2
Others	26.5	29.2	2.7	19.3

Source: The Cambodian authorities.

The solid garment exports performance in 2015 was underpinned by the gradual recovery in major high-income countries, in particular in the Euro area and the US. The recovery, which gained traction in 2015, has been increasingly driven by stronger domestic demand in those economies as labor markets and credit conditions improve.⁵ Garment exports performance is expected to remain strong in 2016, given continuing high growth of imports of fabric, the main input for garment production.

b) Footwear and agricultural commodities

Footwear is rapidly emerging as a major source of exports, largely destined for the EU market. Footwear exports have been growing rapidly at an average annual rate of 35 percent over the past five years. The value of total footwear exports rose to US\$660 million in 2015 (Table 4), from only US\$108 million in 2009. Agricultural commodity exports such as milled rice and rubber exports which experienced high growth in 2015 appears to be partly the result of a low-base effect, given the 20 percent year-on-year decline in the rates experienced by both rubber and milled rice exports in 2014.

Cambodia currently enjoys the EU's Everything-But-Arms (EBA) preferential treatment for its garment exports. However, much more intense competition is expected once

Box 1: The Trans-Pacific Partnership¹

On October 4, 2015, 12 Pacific Rim countries concluded negotiations on the Trans-Pacific Partnership (TPP). If ratified by all signatories, the agreement could raise GDP in member countries by an average 1.1 percent by 2030. It could also increase member countries' trade by 11 percent by 2030, representing a boost to regional trade growth, which had slowed to about 5 percent on average during 2010-14, down from about 10 percent during 1990-2007. To the extent that the benefits of reforms in TPP member countries have positive spillovers for the rest of the world, the detrimental effects of the agreement due to trade diversion and preference erosion on non-members will be limited. The global significance of the agreement depends on whether it gains broader international traction.

The benefits of TPP will mostly derive from reductions in non-tariff measures (NTMs) that benefits services. For TPP members, only 15 percent of the GDP increase would be due to tariff cuts, whereas cuts in NTMs in goods and services will account for 53 percent and 31 percent of the total increase in GDP, respectively.

The largest gains in GDP are expected in smaller, open member economies, such as Vietnam and Malaysia (10 percent and 8 percent, respectively). Both countries will benefit from lower tariffs and NTMs in large export markets and at home, and from stronger positions in regional supply chains through deeper integration. TPP may accelerate structural shifts between industries based on comparative advantage and scale economies. Skilled labor-intensive sectors (such as chemicals, vehicles and machinery) are likely to expand faster in some advanced economies, while unskilled labor-intensive sectors (such as textiles, apparel and metal products) are likely to expand faster in some emerging market member countries.

The 12 member countries are Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the US and Vietnam.
Source: January 2016 Global Economic Prospects, Spillovers amid Weak Growth, January 2016, World Bank.

garment tariff liberalization becomes effective under a free trade agreement between the EU and Vietnam. Similarly, Cambodia's garment exports to the US are likely to face tougher competition once members of the Trans-Pacific Partnership (TPP) receive preferential treatment. (See Box 1 for more details on TPP.)

⁵ Global Economic Prospects, Spillovers amid Weak Growth, January 2016.

Table 4: Rising exports of footwear and milled rice are largely due to improving export performance to the EU.

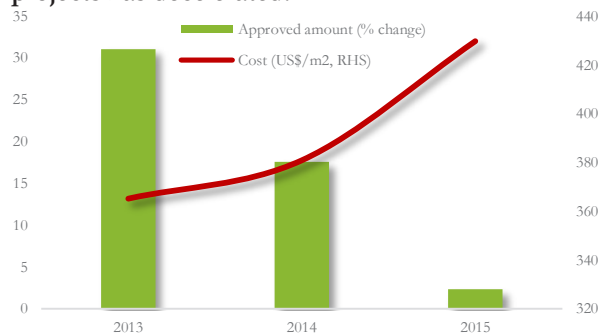
Exports (US\$ million)	2013		2014		2015	
	Value	YoY % change	Value	YoY % change	Value	YoY % change
Footwear	360.35	21.2	471.24	30.7	659.89	40.0
Milled rice	262.27	92.8	210.4	-19.7	315.30	49.8
Rubber	175.17	6.5	138.69	-20.8	165.39	19.2

Source: The Cambodian authorities.

c) Construction and real estate

Construction remains dynamic. Expansion of the construction sector continues apace, focusing in particular on luxury high-rise residential and commercial buildings concentrated in the center of the capital, Phnom Penh. Growth in annual construction permit approvals, however, has decelerated, expanding by just 2.3 percent year-on-year in 2015, compared with 17.5 percent year-on-year in 2014 (Figure 3).

Figure 3. High-end construction building demand is expanding, as seen in the rising average cost per m², while the number of approved construction projects has decelerated.



Source: The Cambodian authorities.

Rising imports of construction equipment and materials, including steel products, continue to support the construction boom (Figure 4). Given the relatively modest size of the domestic market, anticipation of the opportunities arising from implementation of the AEC in 2016 continues to underpin the recent expansion of the

construction sector. This has been facilitated by Cambodia's liberal trade and investment regime.

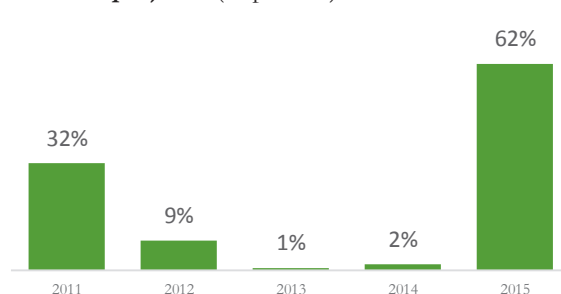
Figure 4: The volume of construction equipments and steel imports is rising as a result of the ongoing construction boom.



Source: The Cambodian authorities

International experience indicates that construction plays a unique role in economic growth and is often a key barometer of economic conditions. Construction increases a country's physical infrastructure, a critical factor in sustaining long-term growth. The performance of the construction sector both affects and is influenced by general economic conditions. Although generally smaller in size than other sectors, its activity has a greater impact on output and employment in the rest of the economy, given its close inter-linkages with other sectors.⁶

Figure 5: Construction and real estate share in total (fixed asset) amount of approved foreign investment projects. (In percent)



Source: The Cambodian authorities

Risks associated with the construction and real estate boom are increasing, given that it has

⁶ The Driving Force behind the Boom and Bust in Construction in Europe, Yan Sun, Pritha Mitra, and Alejandro Simone, IMF Working Paper, WP/13/181.

fueled land and house price speculation across Phnom Penh and in other urban centers, as well as a rapid credit expansion that could eventually lead to the emergence of a bubble. However, unlike traditional housing developments that were mainly financed domestically, the recent surge in modern high-rise residential and commercial building development has been largely undertaken by joint-ventures between local and international partners, and financed mainly by FDI (Figure 5).

d) Tourism

The tourism sector has eased. Tourist arrivals in 2015 grew by 6.1 percent year-on-year (reaching 4.8 million visitors), compared with 6.9 percent in 2014 (Table 5). Arrivals by air moderated most, increasing by 8.9 percent year-on-year in 2015, compared with 12.7 percent in 2014. However, the initial recovery of regional tourism activity, particularly in Thailand, is expected to have a positive impact on arrivals to Cambodia.

Table 5: Arrivals to Cambodia eased further in 2015. However, improving arrivals to Thailand are expected to positively impact tourism activity in Cambodia. (Tourist arrivals, in million)

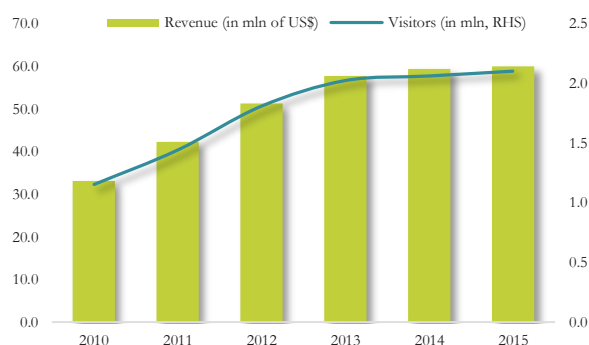
	Cambodia			Thailand			Vietnam		
	2013	2014	2015	2013	2014	2015	2013	2014	2015
Total arrivals	4.2	4.5	4.8	26.5	24.8	29.3	7.5	7.8	7.9
Change (y/y)	17.5%	6.9%	6.1%	18.8%	6.4%	17.7%	12.5%	3.8%	0.8%
o/w Air arrivals	2.0	2.3	2.5	15.4	15.5	18.4*	6.0	6.2	6.3
Change (y/y)	17.2%	12.7%	8.9%	8.7%	1.0%	18.6%	6.8%	4.0%	0.8%

Source: The Cambodian authorities, TAT, Vietnam's Ministry of Culture, Sports and Tourism.

* Based on Jan-Oct 2015 arrival numbers.

Easing tourist arrivals in 2015 slowed revenue collection at the Angkor Archaeological Park, the largest tourist attraction site in Cambodia (Figure 6). In 2015, the number of tourists visiting the park increased by only 2 percent to 2.1 million and its revenue rose by merely 1.2 percent to US\$60.05 million.⁷

Figure 6: Tourist numbers visiting Angkor Archaeological Park decelerated, as did revenue collection at the Park.



Source: The Cambodian authorities.

Asia has become the major source of tourists, contributing almost 85 percent of the total gain in arrivals to Cambodia over the past five years (Table 6). Cambodia has been successful in attracting foreign tourists, with the number arrivals in 2015 at 4.8 million, almost double the 2.5 million arrivals seen in 2010. However, the tourism sector appears to be increasingly dependent on arrivals from Asia, with the contribution of arrivals from Europe declining since 2010. Cambodia's neighbors, namely Vietnam, China, Lao PDR and Thailand, contributed about 70 percent of the total increase of 2.2 million visitors between 2010 and 2015.

Table 6: Asia has become the main source of tourists, contributing almost 85 percent of the total increase in arrivals over the past five years. Contribution to tourist arrivals growth by country of origin since 2011 (In percent)

	2011	2012	2013	2014	2015
Asia	80.1	84.1	83.7	84.6	84.2
Vietnam	26.7	23.1	20.0	19.6	20.9
China	18.6	14.5	16.8	19.2	25.5
Lao PDR	9.7	15.0	18.9	18.4	13.8
Thailand	-8.7	4.9	4.2	6.5	8.9
Europe	14.3	11.3	12.3	11.2	10.1
America	4.9	4.2	3.8	3.9	5.1
Africa	0.4	0.1	0.1	0.1	0.2
Middle East	0.3	0.3	0.2	0.2	0.3
Total	100.0	100.0	100.0	100.0	100.0

Source: The Cambodian authorities.

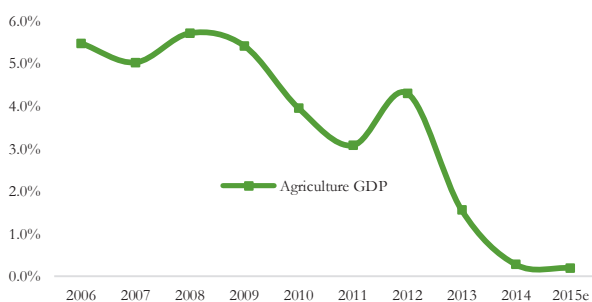
⁷According to the Apsara Authority. For more details, see http://apsaraauthority.gov.kh/?page=detail&menu1=649&ctype=document&id=649&ref_id=13&lg=kh

Increasing tourist arrivals to Thailand (including arrivals by air) bode well for improving arrivals to Cambodia, given the dependence of Cambodia's relatively new tourism sector on Thailand's more developed tourism sector.

e) Agriculture

After sustaining a high growth rate, averaging 5.5 percent in real terms during 2005-13, agriculture GDP growth flattened, expanding just 0.3 percent and 0.2 percent year-on-year in 2014 and 2015, respectively (Figure 7). Less favorable weather conditions, especially intermittent rainfall, over the past few years have had a negative impact on agriculture production. As rice farming remains traditional, falling rice prices appear to have had less negative impact on rice production (than other types of agriculture production, such as rubber and cassava).⁸

Figure 7: Agriculture GDP growth flattened, expanding by just 0.3 and 0.2 percent year-on-year in 2014 and 2015, respectively. (At constant 2000 prices, YoY % change)



Source: The Cambodian authorities.
e= estimates.

The agriculture sector continues to be highly dependent on rainy season rice production. Despite efforts made to improve Cambodia's irrigation system and its diversification of crop production, the agriculture sector continues to depend heavily on wet season rice production, which is heavily reliant on rainfall. As a result, rice production in 2015 is estimated by the authorities

⁸ This is explained by the drop in rice planted areas which was less than that of rice harvested area (and rice production).

⁹ The full report can be accessed at <http://documents.worldbank.org/curated/en/2015/08/24919384/cambodian-agriculture-transition-opportunities-risks>.

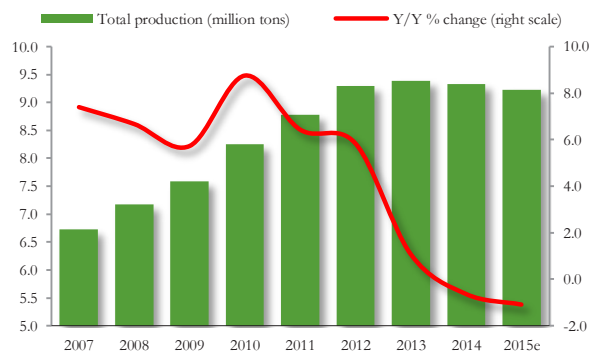
to have dropped by 1.1 percent year-on-year (Table 7). In addition, farmers are facing falling agriculture commodity prices that negatively affect their earnings. This calls for higher productivity to withstand lower prices, and for diversification to less water-intensive crops.

Table 7: Slower rice production in 2015/16 than in 2014/15 was due to less favorable weather conditions.

Rice production	2014/15	2015/16e	Change (%)
Planted area (ha, mln)	3.056	3.027	-0.9
<i>o/w rainy season</i>	<i>2.565</i>	<i>2.562</i>	<i>-0.1</i>
Harvested area (ha, mln)	3.029	2.996	-1.0
<i>o/w rainy season</i>	<i>2.538</i>	<i>2.536</i>	<i>-0.1</i>
Production (metric tons, mln)	9.227	9.329	-1.1
<i>o/w rainy season</i>	<i>7.144</i>	<i>7.175</i>	<i>0.4</i>
Other crops (planted areas in ha)	As of Feb 2015	As of Feb 2016	Change (%)
Corn	24,312	23,483	-3.4
Cassava	12,887	19,641	52.4
Bean	11,442	13,582	18.7

Source: The Cambodian authorities (final wet and estimated dry season rice production, February 2016), <http://www.maff.gov.kh/reports/67-monthlyreport.html>

Figure 8: Rice production peaked in 2013 and has since declined. (In million metric tons)

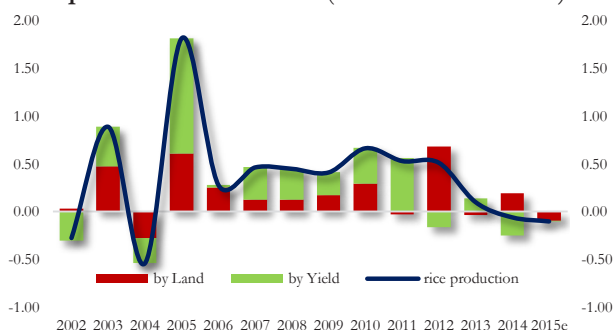


Source: The Cambodian authorities.
e=estimate.

The modernization of agriculture would help to sustain productivity in the long run. As discussed in the Selected Issue of the October 2015 Cambodia Economic Update, the recent report by the World Bank entitled "*Cambodian Agriculture in Transition: Opportunities and Risks*"⁹ suggests that the recent slowdown in Cambodia's

agricultural growth may also signal a longer-term growth decline unless total factor productivity is improved. Figures 8 and 9 illustrate that rice production peaked at 9.39 million metric tons in 2013 and has since decreased, along with declining growth of paddy yields.

Figure 9: Slow yield and cultivated area expansion growth resulted in stagnant and declining annual rice production since 2013. (In million metric tons)



Source: The Cambodian authorities.

In the context of depressed international agriculture commodity prices, new challenges arise. While the 2008 global food price spike provided an opportunity to leverage agricultural growth and made farmland expansion profitable, the recent decline of global food prices and a more competitive global rice market with the reentry of Thailand and Myanmar have put pressure on Cambodia. It is advisable to move the focus from higher production and exports to stronger rice-based farming systems that are diversified, commercial, and resilient to climate change, and supported by a modernized value-chain and cost-effective logistics. Four sets of policies recommended by “*Cambodian Agriculture in Transition: Opportunities and Risks*” taken together can help to support that move. The first is maintaining a private-sector-friendly agricultural policy environment, with added attention to lowering the regulatory burden in farm input sectors. The second is strengthening the environmental sustainability of agricultural production. The third is improving the quality of public agricultural programs and, as feasible within Cambodia’s total government budget, increasing allocations to more effective programs. The fourth is helping to develop the agribusiness and agro-

processing industry. (See the full report for more detailed recommendations.)

Employment, income and consumption

Cambodia’s demographic dividend is contributing towards economic expansion and per capita income growth. The labor force is currently growing faster than the population dependent on it, freeing up resources for investment and family income growth. Unlike many regional countries, Cambodia experienced an increase of the working age population (15-64 years) of almost 1.2 million persons, rising to 10 million in 2014 from 8.8 million in 2009 (Table 8), according to the 2014 Cambodia Socio-Economic Survey (CSES). On average, Cambodia adds 162,000 to its labor force annually, of which 159,000 are employed in the economy.

Table 8: Population and labor force aged (15-64 years) by sex and geographical domain, 2009 and 2014. (In '000 and percent).

Labour force and sex	CSES 2009				CSES 2014			
	Cambodia	Phnom Penh	Other urban	Other rural	Cambodia	Phnom Penh	Other urban	Other rural
Total population	13,967	1,383	1,428	11,156	15,184	1,794	1,796	11,594
Total working age population	8,865	1,001	956	6,907	10,001	1,361	1,219	7,421
Labour force	7,480	688	737	6,055	8,259	1,060	961	6,238
Labour force participation rate								
Women	80.4	61.5	72.7	84.3	77.5	72.2	71.1	79.6
Men	88.8	77.2	82.1	91.3	87.9	84.1	87.3	88.7
Both sexes	84.4	68.7	77.2	87.7	82.6	77.9	78.8	84.1
Employment rate								
Women	80.3	61.4	72.6	84.2	77.4	72.0	71.0	79.4
Men	88.6	76.9	81.7	91.2	87.8	84.0	86.9	88.6
Both sexes	84.3	68.5	77.0	87.6	82.4	77.8	78.6	83.9

Source: 2014 Cambodia Socio-Economic Survey, National Institute of Statistics, October 2015.

Cambodia has also experienced a sharp decline in the share of the employed population working in agriculture, pointing to productivity improvements, given the continued contribution of the sector to economic growth. The agriculture sector’s share of total employed population (aged 15 to 64 years old) shrank by almost 2.5 percent a year during 2009-14, dropping to 45.3 percent in 2014, from 57.6 percent in 2009 shedding half a million jobs (Table 9). During this period, the employment shares of the services and industry sectors rose to 30.4 percent (with additional 0.8 million new jobs) and 24.3 percent

(with additional 0.5 million new jobs) from 26.5 percent and 15.9 percent, respectively.

Table 9: The share of the population employed in agriculture dropped to 45.3 percent in 2014 from 57.6 percent in 2009, shedding half of a million jobs while the services and industry sectors created 0.8 and 0.5 million jobs, respectively. Employed population by industry. (In '000)

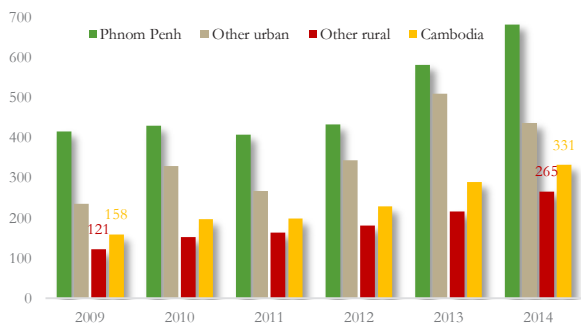
	2009	2014	+/- change
Employed population	7,469	8,235	766
'000			
Agriculture (Primary) 1/	4,302	3,730	-572
Industry (Secondary) 2/	1,188	2,001	814
Services (Tertiary) 3/	1,979	2,503	524
Share (%)			
Agriculture (Primary)	57.6	45.3	-12.3
Industry (Secondary)	15.9	24.3	8.4
Services (Tertiary)	26.5	30.4	3.9
Total	100	100	

Using International Standard Industrial Classification (ISIC Rev 4.0): 1: Agriculture, forestry, and fisheries; 2: Mining & quarrying, manufacturing, electricity, gas, steam and air conditioning supply, water supply, sewerage, waste management and remediation activities and construction; 3: wholesale, retail, repairs, transportation, storage, accommodations, food services, information, communication, financial, insurance, real estate, professional, scientific, technical, administrative activities, public administration, defense, education, health, arts, entertainment, other services activities and more.

Source: 2014 CSES.

Sustained economic growth enabled per capita disposable income to double during 2009-14 (Figure 10). Monthly per capita disposable income of 'other rural' rose fastest, at 120 percent during 2009-14, reaching CR 265,000 in 2014 from CR 121,000 in 2009.

Figure 10: Per capita disposable income of 'other rural' increased fastest during 2009-14. Average per month per capita disposable income in '000 riels.

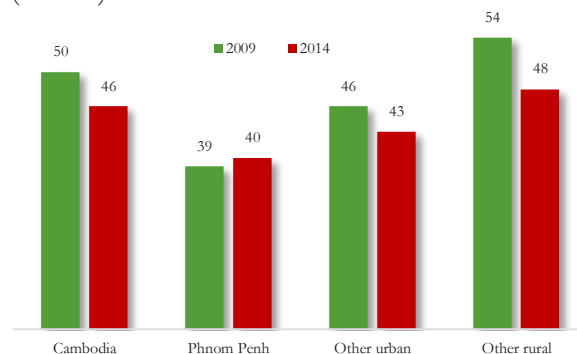


Source: Cambodia-Socio Economic Survey

As the standard of living improved, so the share of food consumption in total consumption declined

in 2009-14 (Figure 11), while the percentage of households who own durable goods, for example, cellphones, motorcycles and televisions, increased rapidly (Table 10).

Figure 11: Share of food consumption in total consumption dropped across geographical domains. (Percent)



Source: 2014 CSES.

Table 10: Ownership of durable goods increased rapidly across geographical domains. Percent of households owning durable goods. (In percent)

Items of durable goods	2009				2014			
	Cambodia	Phnom Penh	Other urban	Other rural	Cambodia	Phnom Penh	Other urban	Other rural
Radio	43	41	45	42	33	34	28	33
Television	60	96	80	53	66	95	83	59
Video tape recorder/player*	29	60	47	23	23	34	27	21
Stereo	14	40	16	10	5	19	4	3
Cell phone	44	93	70	35	83	96	90	80
Satellite dish	1	2	3	1	2	0	2	2
Bicycle	68	45	61	71	61	42	60	64
Motorcycle	49	86	67	43	66	90	74	61
Car	4	20	8	2	5	20	9	2
Jeep/Can	1	3	3	1	1	1	1	1
PC	3	25	7	1	6	28	11	2

Poverty

Sustained robust economic growth during the past two decades has had a significant positive impact on poverty reduction, and the downward trend in poverty is expected to continue for the next few years. The findings of the latest Cambodia Socio-Economic Survey discussed above point to further poverty reduction up to 2014. Per capita GDP is expected to reach US\$1,145.1 in 2015, increasing by 5.6 percent from the level observed in 2014.

However, poverty incidence is believed to be still higher in rural areas than in urban areas. While rural households reaped the benefits of

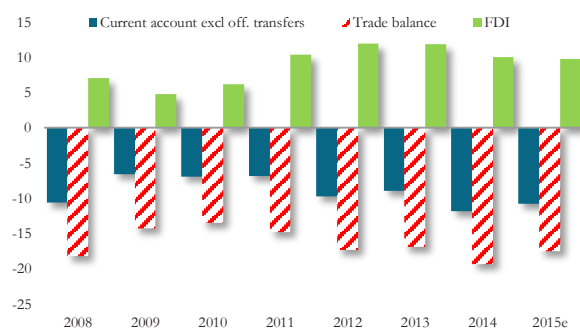
growth in the agricultural sector seen in the period 2008-10, in more recent years, urban households have benefitted from the expansion of the garment and construction sectors. Further reduction of poverty is expected for both urban and rural households throughout 2015-2016. For urban households this is explained by the economic sectors in which they participate (mainly construction and services). For rural households there has been an increase in sources of income different to agricultural self-employment income.

Cambodian households remain highly vulnerable. The recent success in reducing poverty has resulted in many households now living just above the poverty line. The impact of negative shocks (such as droughts, regional unrest, etc.) on poor households is exacerbated because of the limited social protection systems in place.

The external sector

Cambodia's external position remains stable, underpinned by healthy inflows of FDI. As an oil importer, Cambodia benefits from the slump in oil prices, which also has a positive impact on the current account balance. Low oil prices, together with improved export performance, has led to a narrowing of the current account deficit, which declined to 10.8 percent of GDP in 2015, compared with the revised estimation of 11.9 percent of GDP. The deficit is financed by continuing strong FDI inflows, estimated at around 10 percent of GDP in the period 2012-15 (Figure 12). Healthy FDI inflows and a strong garment exports performance have resulted in rising gross international reserves, which reached US\$5.6 billion (or 4.6 months of imports) by end-2015, from US\$4.6 billion in 2014.

Figure 12: Healthy FDI inflows continue to finance the current account deficit. Trade balance, current account balance, and FDI (Percent of GDP)



Source: The authorities and Bank staff estimates.
e = estimate.

a) Exports

As discussed in the real sector above, merchandise exports accelerated in 2015, driven by high growth in garment and footwear exports, and resuming rubber exports. Underpinned by relatively good labor market stability and by the gradual shift towards higher value-added products, garment and footwear exports accelerated in value terms at year-on-year growth rates of 12.3 percent and 40.0 percent in 2015, respectively, compared with 9.2 percent and 30.7 percent in 2014. Growth in total exports accelerated to 15 percent y-o-y in 2015, compared to 7.5 percent in 2014, contributing to the narrowing in current account balance.

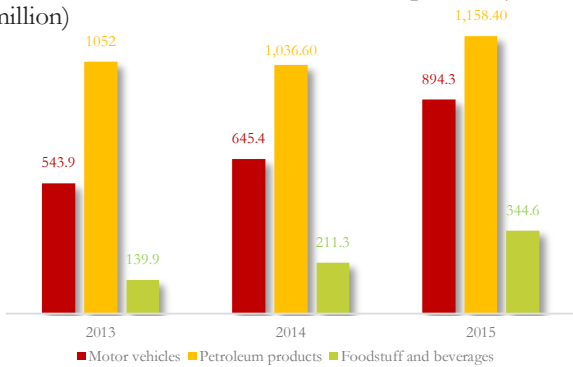
b) Imports

Import growth continues to be driven largely by strong domestic demand for both investment and consumption. While remaining strong, import growth eased to 10.5 percent y-o-y in 2015, compared to 11.9 percent in 2014. The ongoing construction boom has contributed to growth in construction material imports, whereas the recent decline in oil prices is supporting rising demand for petroleum and vehicle imports (Figure 13).¹⁰ Domestic demand pressures are also stimulating imports of consumer goods, especially foodstuff and beverages. Imports of foodstuff and

¹⁰ Another major imported item is the fabric used in the production of garments that are almost entirely for export.

beverages accelerated further, growing by 64 percent year-on-year in 2015.

Figure 13: While motor vehicles imports accelerated due to rising domestic demand, petroleum imports moderated with the decline in oil prices. (In US\$ million)

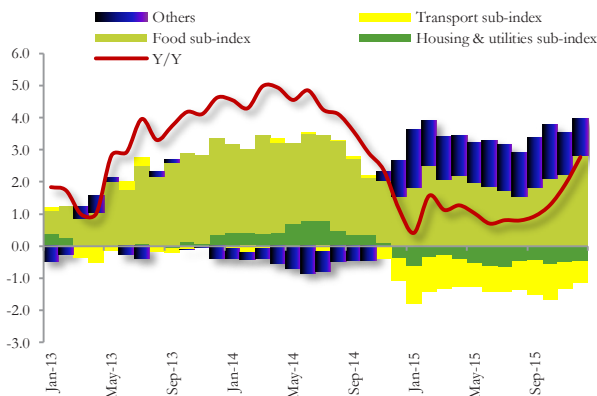


Source: The Cambodian authorities

Inflation

As a result of rising domestic demand, inflationary pressures have increased. Inflation edged up to 2.3 percent year-on-year by February 2016, compared with 1.2 percent by end-2014 (Figure 14). Largely driven by continuing domestic demand pressures, rising food, restaurant, health and furnishings sub-indices have pushed up inflation since the fourth quarter of 2015. Some other sub-indices, such as those for housing, utilities and transport, remain in negative territory.

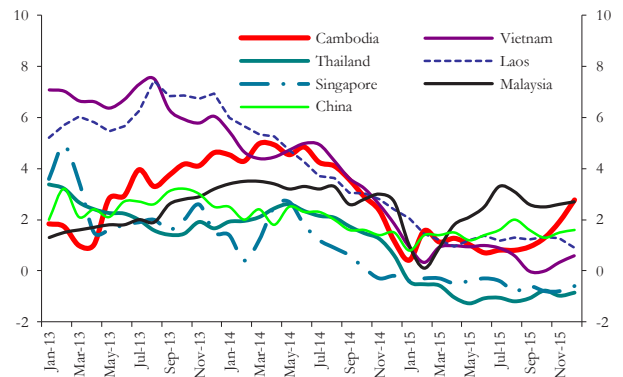
Figure 14: Inflation has edged up slightly due to rising food and other prices (restaurant, health and furnishings). Contributions to 12-m inflation (Percent)



Source: The Cambodian authorities.

Notwithstanding depressed foodstuff and oil prices, regional inflation is mixed. Inflation in Thailand and Singapore turned negative in mid-2015 (Figure 15). Inflation in Cambodia, China and Malaysia, however, has edged up slightly.

Figure 15: Regional inflation is mixed. Inflation in some countries, namely Cambodia, China and Malaysia, has edged up. (YoY % change)



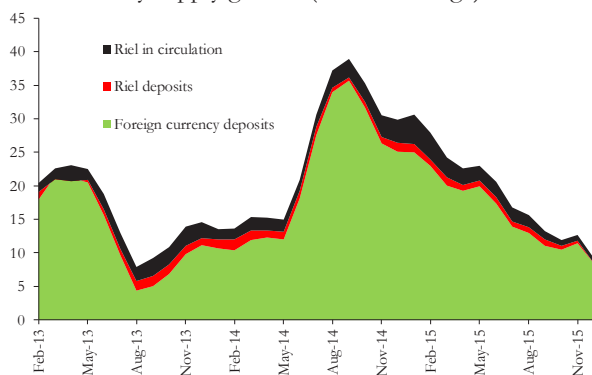
Source: Regional countries' statistics offices.

The monetary sector

a) Monetary aggregates, interest rates, and exchange rates

Broad money growth slowed, although the rapid expansion of the financial sector continued to accommodate economic expansion. Due to the slowdown in foreign currency deposits growth, broad money decelerated to 14.7 percent year-on-year in June 2015, compared with 29.9 percent in 2014 (Figure 16). This may be partly explained by a decrease in global liquidity in anticipation of an increase in US interest rates. During the same period, the contribution from foreign current deposits to broad money declined to 8.3 percentage points in 2015, from 25.1 percentage points in 2014.

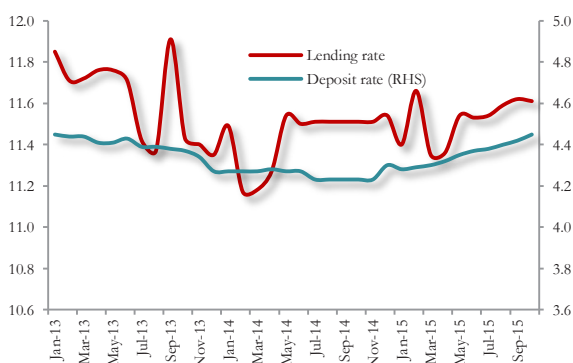
Figure 16: Broad money supply growth eased as foreign currency deposits slowed. Contribution to broad money supply growth (YoY % change)



Source: The Cambodian authorities.

Slower growth of foreign currency deposits may have exerted some pressures on lending and deposit interest rates, which have been edging up since early 2015 (Figure 17). The weighted average of 12-month US dollar deposit rates increased to 4.45 percent in 2015, up from 4.3 percent in 2014, while the 12-month US dollar lending rate also rose to 11.61 percent, from 11.54 percent in the same period. The interest rate spread—the difference between the nominal lending and deposit rates—narrowed slightly to 7.16 percent in 2015, down from 7.24 percent in 2014, as the lending rate hike was more than offset by deposit rate increases. The spread, however, remains large.

Figure 17: 12-month deposit and lending rates edged up. (Percent per year)

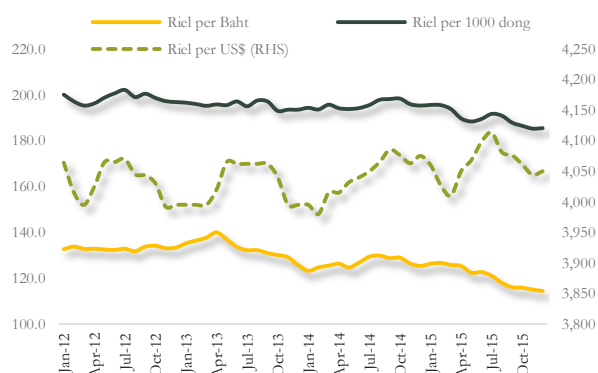


Source: The Cambodian authorities.

Overall price stability remains underpinned by the stable Cambodian riel versus the US dollar

exchange rate. The riel appreciated slightly, reaching CR 4,008 per US dollar in February 2016, compared with CR 4,075 per US dollar in December 2014. Appreciation of the riel against the Thai baht (and the Vietnamese dong) also continued, reaching CR 114.9 per baht in February 2016, compared with CR 125.3 per baht in December 2014 (Figure 18).

Figure 18: The riel has continued to gain against the baht and dong, and now against the US dollar.



Source: The Cambodian authorities.

The nominal effective exchange rate (NEER) and the real effective exchange rate (REER) have experienced an accelerated appreciation after the second half of 2015. The NEER index (2010=100) rose to 113.8 in January 2016 from 106.7 in December 2014 while the REER index (2010=100) increased to 122.9 in January 2016 from 113.1 in December 2014. The appreciation is exerting pressures on the balance of payments and growth.

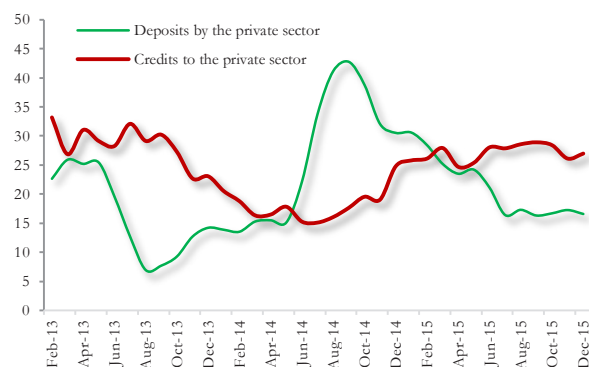
b) The banking sector

Rapid financial deepening continues. Private sector credit growth remained high, at 27 percent year-on-year, or US\$9.8 billion, by end-2015, compared with 24.8 percent year-on-year at end-2014 (Figure 19). Private sector deposits growth, however, halved to 16.6 percent year-on-year, or US\$10.3 billion, by June 2015, compared with 30.6 percent year-on-year at end-2014, in the context of global financial volatility. The loan-to-deposit ratio, therefore, rose to 95.6 percent. For a more detailed discussion on “Recent Developments of the

Financial sector: Opportunities and Risks” see the selected issue section below.

Deceleration in foreign currency deposits may obey external conditions. With its highly dollarized economy, and with one-third of its exports going to the US, Cambodia seems to be influenced by US monetary policy and the US business cycle. Cambodia’s economic cycle seems to have moved in sync with that of the US.

Figure 19: High credit growth continued while deposits growth halved in 2015. (YoY % change)

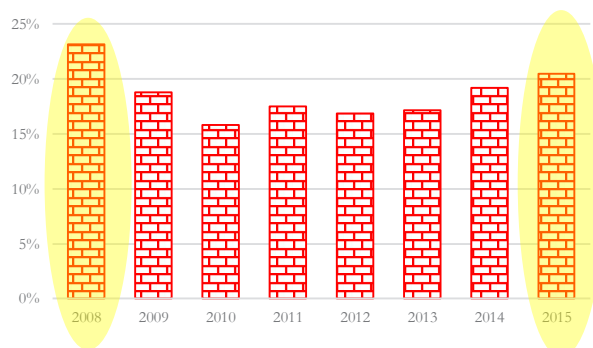


Source: The Cambodian authorities.

The share of domestic credit provided to the construction and real estate sector increased further, reaching 20 percent of total domestic credit in 2015, compared with 19 percent (or US\$1.8 billion) in 2014 (Figure 20). The share, however, remained below the peak of 23 percent in 2008, in the run up to the global financial crisis when the housing bubble in Phnom Penh eventually burst. This had limited impact on the economy and the banking sector because the construction and real estate sector was largely foreign financed at that time.

The expansion of the banking sector continues to squeeze banks’ net foreign assets. At present, the rise in foreign liabilities more than offsets the increase in foreign assets (Figure 21). In view of this, the central bank has introduced reserve requirements of 12.5 percent for foreign borrowing.

Figure 20: Loans and mortgages to the construction and real estate sector rose further in 2015. (Percent of total)



Source: The Cambodian authorities.

To further strengthen the banking sector, the liquidity coverage ratio and, more importantly, the recent directive (Prakas) of March 22, 2016, on minimum registered capital of banking and financial institutions issued by the central bank, have been introduced. The directive stipulates that the new capital requirements (Table 11) will be met within two years of signing.

Table 11: Minimum capital requirements (Equivalent in US\$ million)

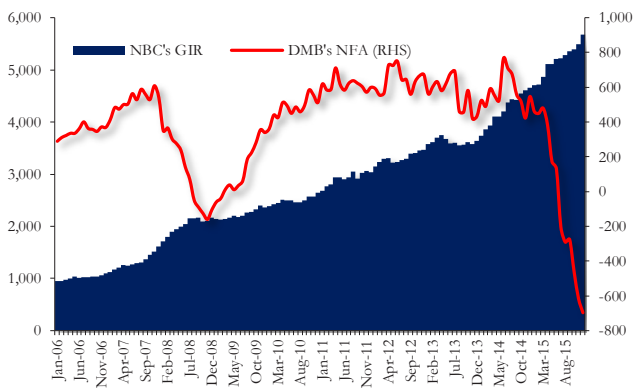
Types of banks or financial institutions	Requirements	
	Previous	New
Locally incorporated commercial banks	37.5	75
Branches of foreign banks	12.5	75
Branches of investment-grade foreign banks	12.5	50
Specialized banks	7.5	15
Deposit-taking microfinance	2.5	30
Microfinance	0.625	1.5

Source: The Cambodian authorities

With strong FDI inflows and exports, the central bank’s gross international reserves rose, reaching US\$5.6 billion (or 4.6 months of

prospective imports) by the end of 2015.¹¹ This compares with US\$4.6 billion at the end of 2014.

Figure 21: Banks' NFAs declined as the rise in foreign liabilities more than offset the increase in foreign assets. (US\$ million)



Note: FC: foreign currency, GIR: gross international reserves, NFA: net foreign assets, DMB: deposit money bank.

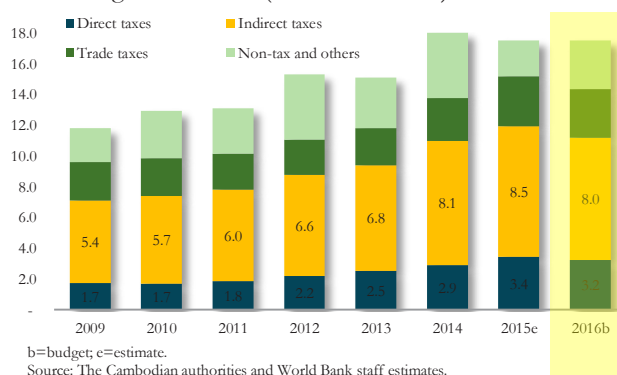
The fiscal sector

Fiscal consolidation underpins macroeconomic stability and contributes to the accumulation of government deposits. Despite slightly weaker economic performance, improved revenue administration boosted domestic collection, estimated to have reached 17.5 percent of GDP in 2015. Total expenditure was contained at 20.5 percent of GDP, as public sector wage increases were offset by a decline in capital spending. This resulted in an improved overall fiscal deficit (including grants) of 0.8 percent of GDP in 2015, compared with 1.4 percent in 2014 (Figure 25). The introduction of full program-based budgeting since 2015 has supported budget-policy linkage and improved accountability and results. Service delivery units, mainly schools classified as budget entities, have started to directly receive funds from the national level and are accountable for the funds they manage. Initial challenges in implementing program-based budgeting, however, slowed disbursements during the first half of 2015.

a) Revenue composition

Strong revenue performance continues, outperforming the targets set forth in the 2014-18 Revenue Mobilization Strategy (RMS). Tax revenue increased from around 10 percent of GDP in 2010 to 15.1 percent in 2015, thanks to improved enforcement and auditing mechanisms set out in the RMS, among others. When including non-tax revenue, total collection, estimated at 17.5 percent of GDP in 2015, was slightly below that of 2014 (Figure 22).

Figure 22: As a result of improved administration, domestic revenue has risen substantially since 2014. General gov't revenue. (Percent of GDP)



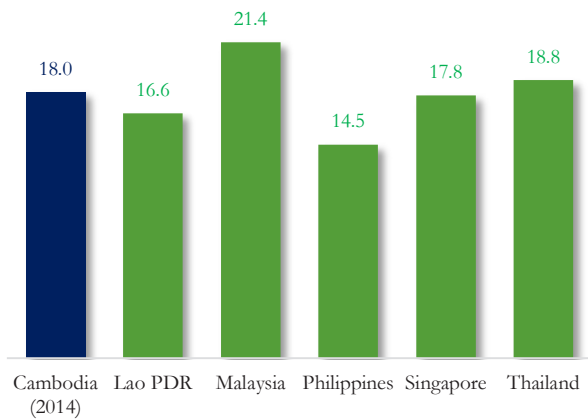
b=budget; e=estimate. Source: The Cambodian authorities and World Bank staff estimates.

The composition of revenue collection seems to slowly move towards direct taxation. An increase in direct tax collection was observed in 2015, whereas trade-related collection declined as required under ASEAN Free Trade Area.

Regional comparisons also show that Cambodia performs well in revenue collection when measured against a number of its neighbors (Figure 23). Cambodia has significantly improved revenue collection over the past few years, and presents nowadays levels similar to those of other ASEAN countries. Relative to GDP, Cambodia collected more revenue in 2014 than the Philippines and Lao PDR did in 2012 (latest available revenue data).

¹¹ Includes all foreign exchanges including Chinese Yuan used as reserves.

Figure 23: Cambodia's revenue collection compares well respect to neighbouring countries. Revenue excluding grants (Percent of GDP, 2012)



Source: World Development Indicators

The World Bank has now been engaged to strengthen revenue administration at a number of key revenue agencies, in particular the General Department of Taxation. This is in addition to the support provided in the overall reform of public finances under the Public Financial Management Reform Program. World Bank support currently focuses on compliance management, including taxpayer services, and tax audits.

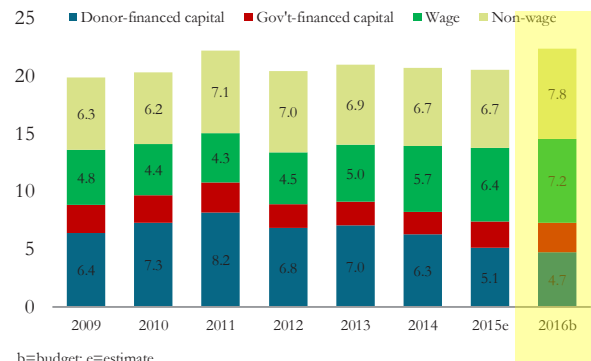
b) Expenditure composition

Public expenditure has been characterized by a continuing rapid wage bill increase, offset by a decline in public investment to contain overall government spending. The wage bill rose to 6.4 percent of GDP in 2015, from 5.5 percent in 2014 (Figure 24). Wages are likely to remain on the rise as the minimum basic monthly salary is targeted to increase to at least CR 1.0 million (equivalent to US\$250) by 2018. Efforts have been made to link the rising wage bill with improvements in human resource management and public service delivery under a civil service reform initiative. However, public sector reform will likely only produce meaningful results in the medium term.

International experience shows that the following institutional factors may improve public sector performance: (i) well-defined roles, responsibilities and accountability; (ii) appropriate human resource management practices; and (iii) in the education and health sectors, there is evidence that increasing the scale of operations may improve efficiency.¹²

It is important to sustain capital expenditure, which has shrunk as a percentage of GDP. Development partner-financed capital budget declined further, from 6.3 percent of GDP in 2014 to an estimate of 5.1 percent of GDP in 2015, as the country has now reached lower middle-income status. This may pose a challenge in the future, since improved infrastructure is urgently needed to enhance the country's competitiveness and achieve more balanced economic development. Most ministries continue relying on donors to build infrastructure, whereas capacity to build it on their own remains limited.

Figure 24: The rising wage bill was offset by declining externally-financed investment, containing overall spending. Gov't spending (Percent of GDP)



b=budget; e=estimate.

Source: The Cambodian authorities and World Bank staff estimates.

To counter this trend, authorities are planning to scale-up public-financed investment. Domestically financed capital, mainly in operations and maintenance, increased from 1.9 percent of GDP in 2014 to 2.3 percent in 2015, and a further increase is envisaged in the 2016 budget. The Government is also revisiting public

¹² Improving Public Sector Efficiency: Challenges and Opportunities by Teresa Curristine, et al., OECD Journal on Budgeting Vol. 7 – No. 1, 2007

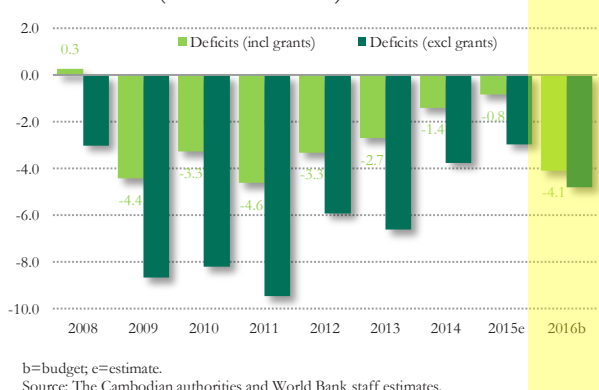
investment management procedures, as well as the Concessions law, to allow for a most robust framework for both public investment and public-private partnerships.

c) Fiscal balance

Buoyant revenue collection and contained overall spending have resulted in a narrowing of the overall fiscal deficit (including grants), estimated to reach 0.8 percent of GDP in 2015. This compares with 1.4 percent of GDP in 2014. Excluding grants, the overall fiscal deficit also narrowed to 3.0 percent of GDP, compared with 3.8 percent of GDP in 2014. The fiscal deficit continues to be financed by external funds.

Rising domestic revenue has continued to enable the government to accumulate deposits. Deposits rose to 9.0 percent of GDP, or US\$1.6 billion, at the end of 2015. The accumulation of government deposits provides a cushion that the government can use during times of shocks. Previously, Cambodia introduced a fiscal stimulus, amounting to about 2 percent of GDP, to mitigate the negative impacts of the 2008-09 global financial crisis. Fiscal policy has been largely the sole policy instrument to maintain macroeconomic stability and to mitigate shocks, as the country's monetary policy is constrained by its high level of dollarization.

Figure 25: The fiscal deficit has improved as a result of fiscal consolidation efforts. General gov't fiscal deficit (Percent of GDP)

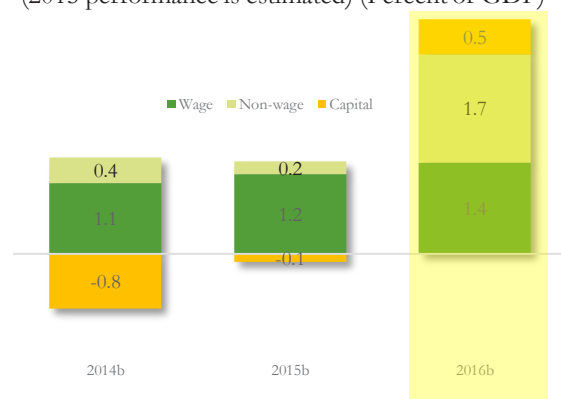


¹³ The relative increase will be smaller if actual disbursement for 2015 is higher than the estimated disbursement of CR 15,340 billion.

d) Annual budget for 2016

The 2016 annual budget can be categorized as expansionary. In absolute terms, total expenditure for 2016 is budgeted to surge to CR 18,288 billion, an increase of CR 2,948 billion, or 3.6 percent of GDP, compared with the estimated level of CR 15,340 billion disbursed in 2015.¹³ This is the largest increase in recent years (Figure 26). Of the total 3.6 percent of GDP increase, non-wage, wage and capital investment are boosted by 1.7 percent, 1.4 percent, and 0.5 percent of GDP, respectively. The total expenditure in the 2016 budget represents 22.3 percent of GDP.

Figure 26: A surge in total spending is budgeted in 2016. Budgeted increases versus previous year's actuals (2015 performance is estimated) (Percent of GDP)



Source: The Cambodian authorities and World Bank staff estimates.

The wage bill is budgeted to reach a record high of 7.2 percent of GDP in the 2016 budget. Given the target of achieving a minimum public sector basic wage of at least CR 1 million (or US\$250 equivalent) a month by 2018, annual wage budget increases need to be closely monitored.¹⁴

The non-wage component receives the largest boost in 2016, having been compressed since 2011. The rising non-wage component may help to ensure that priority spending, including operations and maintenance budgets, are adequately funded. Detailed budget data, however, are not available to confirm this.

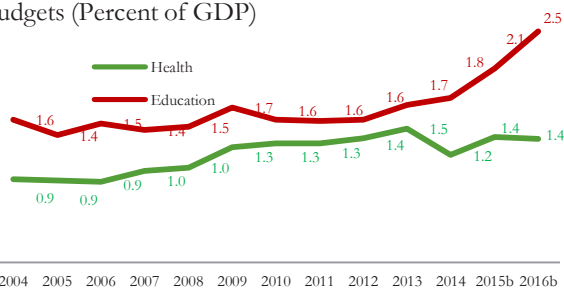
¹⁴ Public forum on 2015 budget law (risks and challenges section), December 22, 2015, Ministry of Economy and Finance.

The capital budget for 2016, however, continues to be contained. The externally-financed (development partner-funded) component is budgeted to shrink further to 4.7 percent of GDP in 2016, declining from 5.1 percent of GDP in 2015. This is likely to pose a challenge in the future, since improved infrastructure is urgently needed to enhance the country's competitiveness and achieve more balanced economic development.

Good revenue performance is expected to continue in the 2016 fiscal year. It is, therefore, projected that the authorities will meet the target of 17.5 percent of GDP in 2016 as budgeted. While domestic revenue budgeted for in the 2016 fiscal year, at 17.5 percent of GDP, is similar to the level of the estimated collection in 2015, it is substantially higher than the 16.3 percent of GDP target set in the RMS. The revenue for 2016 continues to rely on indirect tax, but a larger direct tax contribution, increasing to 3.2 percent of GDP (from 2.8 percent of GDP budgeted in 2015) is targeted. Non-tax revenue of 2.26 percent of GDP budgeted for in 2016 is below the target of 2.4 percent of GDP set in the RMS.

The fiscal deficit including grants is, therefore, budgeted to widen to 4.1 percent of GDP in 2016, compared with 0.8 percent of GDP estimated for 2015. This is due largely to the surge in budgeted total expenditure, together with a declining grants component.

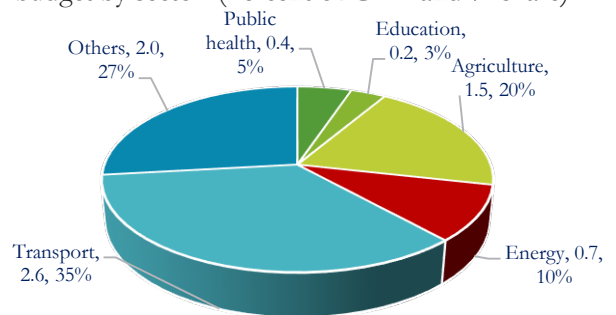
Figure 27: MoEYS receives another boost in the 2016 budget, while MoH remains almost unchanged relative to GDP. Domestically financed budgets (Percent of GDP)



Source: The Cambodian authorities.
b=budget.

Allocations to the social sector continue to improve in 2016. The domestically-financed budget for the Ministry of Education, Youth, and Sports (MoEYS) continues to rise, reaching 2.5 percent of GDP in 2016 (Figure 27). The 2016 budget for the Ministry of Health (MoH), however, remains at 1.4 percent of GDP as spending efficiency continues to be further strengthened. In absolute terms, the budgets for the MoEYS and the MoH rose to CR 2,069 billion, equivalent to US\$510 million (or a 29 percent year-on-year increase) and CR 1,110 billion, equivalent to US\$274 million (or a 8.4 percent year-on-year increase), respectively.

Figure 28: Transport continues to receive the largest share of capital budget. 2016 capital budget by sector. (Percent of GDP and % share)



Source: The Cambodian authorities

Note: The education sector covers education and vocation training ministries; the agriculture sector covers agriculture, rural, water, and environment ministries; and the transport sector includes transport, aviation, and telecommunication ministries.

The transport sector continues to receive the highest priority, absorbing more than one third of the total capital budget. The agriculture, energy, and health sectors follow next, receiving 20 percent, 10 percent, and 5 percent of the total capital budget, respectively.

The 2016 budget adopted late last year pursues continued budgetary reform with the expansion of full program-based budgeting. This is envisaged in the Concept Paper on Strategic Direction of Reform of Budget System (2013-20). Implementation of full program-based budgeting has been broadened to cover an additional 15 ministries and agencies.¹⁵ Program-based budgeting now accounts for about 57

¹⁵ Those 15 ministries/agencies are: Information, Environment, Social Affairs, Civil Aviation (State Secretariat), Commerce, Posts and

Telecommunication, Tourism, Water Resource and Meteorology, Supreme Court, Appeal Court, the National Assembly, the Senate, Foreign Affairs

percent of the total (domestically-financed) current budget appropriated to line ministries and agencies.

The World Bank/IMF debt sustainability analysis (DSA) conducted in 2015 indicates that Cambodia's debt distress rating remains low, with all debt burden indicators projected to remain below their respective thresholds. The results also indicate that debt sustainability continues to be vulnerable to shocks to economic growth, exports and the fiscal position, calling for continued structural reforms to bolster the economy's resilience against external shocks, and to mobilize domestic revenues. At the end of 2014, the estimated stock of Cambodia's external public debt, including arrears, stood at around US\$5.5 billion, or 33 percent of GDP.

Note that Cambodia's debt distress rating has been consistently low since 2011. This is mainly underpinned by the overriding principle of balanced budgeting of the fiscal position and borrowing only on concessional terms.¹⁶

and International Cooperation, National Audit Authority, and Anti-Corruption Unit. Source: 2016 Budget Law. In 2015, program budget covers only ten ministries education, health, rural development, agriculture,

women's affairs, labor, land, public works, justice, and finance. For more details, see www.pfm.org.gov.

¹⁶ The concessional terms borrowed are those with a grant element of 35 percent or above.

C. Outlook and risks

Growth is expected to reach 6.9 percent in 2016, partly underpinned by a significant increase in government spending. Strong garment sector exports are expected to help to offset weakness in the agriculture sector, while the foreign direct investment-driven construction will continue to be a major engine of growth. In the mid run growth is expected to remain right below 7 percent (Table 12).

Further reduction of poverty is expected for both urban and rural households throughout 2015-2016. For urban households this is explained by the economic sectors in which they participate (mainly construction and services). For rural households there has been an increase in sources of income different to agricultural self-employment income.

Robust export growth will also support a narrower current account deficit, forecasted below 10 percent in 2016 and 2017. Exports of goods are expected to continue growing at two digits, supported by economic recovery in Europe. Import growth is expected to gradually ease as construction permit approvals declined in 2015.

Fiscal policy is expected to remain expansionary in the short to medium term. The 2016 budget reflects expansionary fiscal policy, with spending increasing by 3.6 percent of GDP, of which 1.4 percent is due to rising wages and the rest to capital expenditure and non-wage spending. This is likely to continue in 2017 and 2018, in the context of Commune and General elections.

Increasing external competition could result in lower than expected growth in the medium to long term. Given the narrow production and export base and garment exports (about 70 percent of total) heavily concentrated in the EU and US markets, the economy is exposed to mounting competition. With the Trans-Pacific

Partnership (TPP) and the free trade agreement (FTA) between Vietnam and the EU, there are significant risks of investment and export diversion away from Cambodia unless key constraints, such as high energy costs, regulatory impediments to doing business, and infrastructure bottlenecks, are successfully addressed.¹⁷ This could gradually constrain growth unless key structural reforms discussed in the recommendations section below are proactively addressed.

The rapidly expanding financial sector has been supportive of growth, but poses also some challenges. At 38 percent, credit growth to the construction sector continued to grow fast in 2015. While being relatively shielded from external financial volatility, the economy remains dependent on bank flows in the form of foreign currency deposits. Given the limited room for monetary policy and the impossibility for the Central Bank to act as a lender last resort due to high dollarization, as well as the absence of an inter-bank market, continued high domestic credit growth increases the risks to financial stability in Cambodia. Nonetheless, the Central Bank's directive (Prakas) issued in March 2016 doubling banks' capital requirements is expected to help strengthen the rapidly expanding banking sector.

Other downside risks to this outlook include potential labor unrest, continued appreciation of the US dollar in a context of dollarization, slower economic recovery in Europe, spillovers from a slowdown in the Chinese economy. A hard landing of the Chinese economy would dampen growth prospects, mainly due to potentially lower Chinese tourist arrivals in the short term and slower FDI inflows in the medium term. While Cambodia is likely to be shielded from financial volatility due to its limited capital markets, bank inflows remain sensitive to public confidence and market perceptions.

¹⁷See the full report on Cambodia Investment Climate Assessment (2014) at <http://documents.worldbank.org/curated/en/2014/01/23946799/cambodia-investment-climate-assessment-2014-creating-opportunities-firms-cambodia>

Table 12: Selected Economic Indicators, projections 2016 – 2018

	2014	2015e	2016p	2017f	2018f
Real GDP (% change yoy)	7.1	7.0	6.9	6.8	6.8
GDP at factor cost, at market prices (% change yoy)	6.8	7.1	6.8	6.8	6.7
Agriculture	0.3	0.2	0.1	1.4	1.1
Industry	10.1	11.7	9.7	7.3	6.8
Services	8.4	7.4	8.0	9.1	9.2
Inflation (eop, % change)	1.2	2.8	3.0	3.5	3.8
Fiscal balance including grants (% of GDP)	-1.4	-0.8	-2.8	-2.9	-4.1
Exports, goods & services (% change yoy)	8.6	9.2	14.9	9.1	11.7
Imports, goods & services (% change yoy)	10.7	7.4	9.6	9.9	11.6
Current account balance excluding official transfers (% of GDP)	-11.9	-10.8	-9.3	-9.3	-10.0
Foreign direct investment, mn of US\$	1,677	1,803	1,653	1,748	1,780

Source: The authorities and World Bank staff estimates and projections.
e = estimate, p = projection, f=forecast

D. Key Messages and Policy Options

The risks of being so heavily dependent on EU and US markets for Cambodia’s narrowly concentrated garment products are rising. The economy is exposed to greater competition, given the potential negative impacts for Cambodia of the TPP and the FTA between Vietnam and the EU in the medium- to long-term timeframe. As identified by the latest investment climate assessment, the key constraints, such as high energy costs, regulatory impediments to doing business, and infrastructure bottlenecks, need to be proactively addressed to enhance external competitiveness.

Improving the overall business environment would enhance competitiveness across sectors, underpinning product and market

diversification as envisaged in the Industrial Development Policy (IDP), while also helping firms to be well prepared to take advantage of the single market and production base goal set by the AEC. Addressing the key constraints, namely high energy costs and infrastructure bottlenecks, point to a need to scale up public investment to sustain external competitiveness.

A better trained and skilled workforce will certainly help taking advantage of Cambodia’s demographic dividend. To complement the ongoing Global Partnership for Education basic education project, the government has requested IDA funding to improve outcomes in lower secondary education. The education budget significantly increased to 17.1 percent of the national budget in 2015 (16.2% in 2014). National Assessment System (NAS) has been institutionalized, and its results are used to inform policy planning. Key challenges going forward include improving the quality of public service delivery.

In order to remain competitive, the authorities could also consider progressively increasing budget allocations to productive and competitive investment projects. As Cambodia becomes a lower middle-income economy, it is experiencing a gradual decline in development-partner financing, in particular grants. Cambodia is currently still reliant on development partners to build physical infrastructure (from roads to schools). While in the medium term concessional borrowing may increasingly come from regional sources, such as the newly established Asian Infrastructure Investment Bank (AIIB), as well as from bilateral sources such as Japan and China, steadily declining development partner-financed public investment will also require a short-term response whereby additional allocations come from the government budget. Careful prioritization of expenditures and continued buoyant revenue collection will help to make this affordable, if increases in the wage bill can be curbed. Meanwhile, it will also be necessary to further strengthen the rules and regulations governing the management of capital investment

projects, as envisaged by a public investment management assessment currently under discussion.

A Public Investment Management (PIM) assessment under discussion would help strengthening the framework for government-financed capital. While Cambodia uses standard operation procedures for its development partner-financed projects, the government's own investment guidelines are loose and vary across ministries. The ongoing PIM exercise supported by the World Bank Group is expected to help to strengthen the ability of the government to plan, appraise, budget, implement and monitor infrastructure projects by identifying a series of feasible measures for improvement in the different areas. The Government is also revisiting the Concessions law, to allow for a most robust framework for both public investment and public-private partnerships.

Enhanced supervision and inter-institutional coordination could be considered to safeguard financial stability. Information deficiencies and a large 'shadow banking' market make it difficult to quantify the risks more precisely. First and foremost, several gaps need to be addressed in the collection of data, such as those for non-performing loans, related-party exposures and country-risk exposures. These tasks can be tackled in the short term. Further improvement of supervision capacity, while strengthening and developing necessary indicators to support early warning systems so that measures can be developed to mitigate systemic risk, could be addressed in the medium term. It will also be important to improve inter-agency coordination by deepening the existing collaboration, data-sharing, clarity on roles and responsibilities in a crisis, and enhancing crisis-preparedness capacity.

Strengthening of the regulatory framework would be advisable to ensure macro-financial stability. The continued rise of the loan-to-deposit ratio, contributing in part to the ongoing construction boom, warrants also close monitoring. Authorities have introduced some

important measures recently, including increasing the capital requirement of financial institutions, the reserve requirement for foreign borrowing, and the liquidity coverage ratio.

Fast growth in microfinances would require also from consumer protection and increasing financial literacy. As more people shift to formal savings, there is a need to build a financial safety net, underpinned by strong prudential supervision, regular information-sharing between the government and regulators, and a back-up arrangement from the government budget. At the household level, several years of rapidly expanding microfinance and bank credit have enabled Cambodia to make rapid progress in extending financial services to the poor and to rural areas. However, rapid micro-credit growth may lead to over-heating, and several anecdotes point to the poorest heading towards over-indebtedness, with limited financial literacy possibly enabling market abuses. Therefore, it will be essential to ensure successful implementation of the recent directive doubling capital requirements by promoting consolidation and mergers, which can help underperforming banks and microfinance institutions to become healthy.

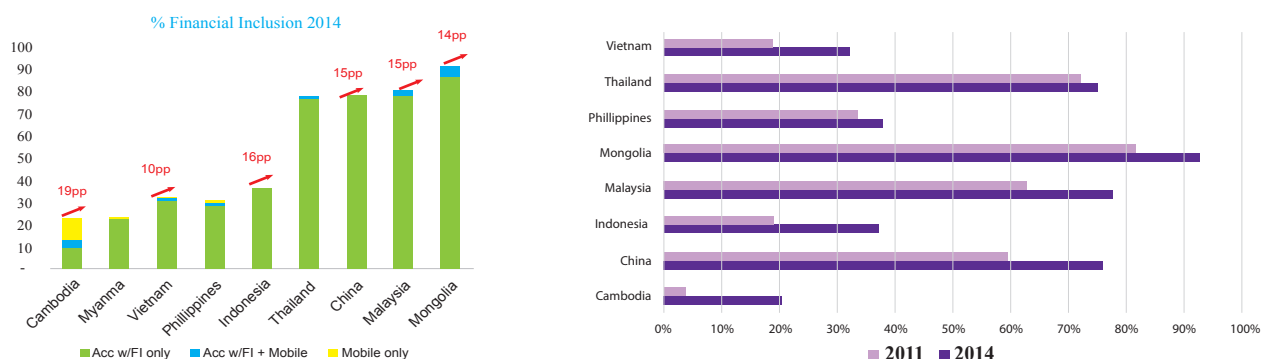
International experience points to a framework of minimum standards for sound banking supervisory practices that are universally applicable. These include: (i) clearly defined supervisory powers; (ii) responsibilities and accountabilities among supervisory authorities; and (iii) appropriate prudential regulations. A number of preconditions for effective banking supervision are: (i) a well-established framework for financial stability policy formulation; (ii) a clear framework for handling a crisis situation; and (iii) an appropriate level of systemic protection (or a public safety net). For a more detailed discussion and recommendations, see the selected-issue topic "Recent Developments of the Financial Sector: Opportunities and Risks" in the selected-issue section below.

E. Selected Issue – Financial Sector Developments: Opportunities and Risks

a) Financial sector overview and trends

Starting from a low base, Cambodia’s financial market is deepening quickly, underpinning robust economic growth. The ratio of broad money (M2) to GDP increased from 53.4 percent in 2013 to 66.3 percent by end-2015.¹⁸ Financial institutions’¹⁹ assets, deposits and loans represented 109 percent, 57 percent, and 54 percent of GDP, respectively at end-2015. Underpinned by improving confidence, the financial sector²⁰ has undergone a rapid transformation, with more financial products being developed and introduced. While the banking sector continues to dominate the financial market, with a rapid increase in the number of banks entering Cambodia in recent years, the microfinance sector is also expanding rapidly. As of February 2016, the financial system comprised 36 commercial banks;²¹ 11 specialized banks;²² 34 microfinance institutions; seven microfinance deposit-taking institutions, together with 36 registered microfinance operators; six financial leasing companies; and five third-party payments processors. The insurance sector comprises nine insurance companies (six non-life and three life), one reinsurer and three micro-insurer.²³ With the recent introduction of the Cambodia Securities Exchange, three companies have been listed, while six securities underwriters, one securities dealer and three securities brokers have emerged. The number of financial institutions has increased rapidly in the past few years and resulted in a six-fold increase in financial inclusion data to 23 percent in Global Findex Survey 2014 (Figures S1 and S2) and increased to 51.41 percent in 2015, based on the public data.²⁴ However, interest spreads in the Cambodian riel and US dollar for one-year maturity remain wide, at 9.43 percent and 7.16, respectively, in July 2015.

Figures S1 and S2: Comparison of Financial Inclusion: (1) Cambodia increased by 19 percentage point (pp) from 2011 to 2014 and (2) poorest 40 percent group also increased dramatically.



Source: 2014 World Bank's Global Findex Report

¹⁸ As reported in the December 2015 monetary survey.

¹⁹ Licensed banks and microfinance institutions.

²⁰ The financial sector comprises banks and microfinance institutions regulated by the National Bank of Cambodia (NBC), insurance companies and non-financial service-providers like real estate brokers, audit and accounting firms regulated by the Ministry of Economy and Finance (MEF), and securities companies, brokers, dealers regulated by the Securities Exchange Commission of Cambodia (SECC).

²¹ Of the 36 commercial banks, there are 13 locally incorporated, 12 foreign subsidiaries, and 11 foreign branches.

²² Of the 11 specialized banks, there are one state-owned, four local majority ownership, six foreign majority ownership.

²³ There is also an NGO which is licensed as Community Based Health Insurance Implementer provider.

²⁴ The financial inclusion computation (based on the latest available data) is as follows: 2.3 million depositors with the banking sector (2015), 2.3 million borrowers with the microfinance sector (2014), and 0.6 million account holders with WING, totaling 5.244 million. Estimated number of a adult population is 10.2 million of out 15 million population. Therefore, financial inclusion is 51.4 percent (5.244/10.2). Data on financial inclusion, however, vary with some sources show higher financial inclusion than others.

b) The banking sector

The rapidly expanding banking system supports economic growth, while competition among banks reduces borrowing costs and improves access to finance. Total credit provided by the banking system rose to 54 percent of GDP, serving 2.3 million borrowers in 2015, compared with only 27 percent of GDP, lending to just over a quarter of a million borrowers in 2010.²⁵ Borrowing costs have been substantially reduced, as the weighted average of short-term lending rates dropped to 11.6 percent per year in 2015, down from 22.04 percent per year in 2010.

Despite strong competition, the banking system remains concentrated. The top five banks account for more than half of all banking sector assets. The banking

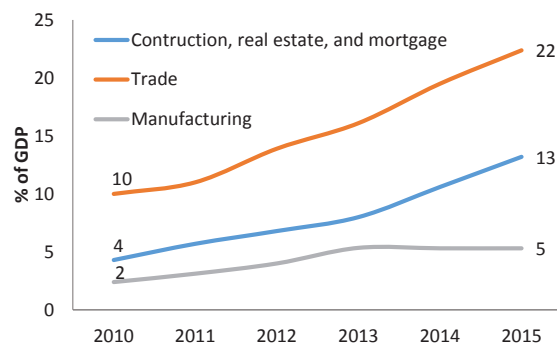
system experienced an asset growth rate of about 30 percent each year in the period 2010-14. Improved confidence in the banking system encouraged private sector deposits, which grew at an average rate of 23 percent per year over the same period. Growth of banks' assets and deposits, however, has moderated recently, decelerating to 22.1 percent and 16.6 percent, respectively, at the end of 2015. Meanwhile, outstanding credit provided by the banking system continues to increase rapidly, reaching about 30 percent year-on-year in the past five years. Banks' loan-to-deposit ratio, therefore, increased to 96 percent at end-2015 from 87 percent at end-2014.

Credit growth continues to provide necessary financing to facilitate a surge in investment and an increase in domestic consumption, with a growing middle-class in the context of a largely stable political and institutional environment. The authorities are encouraged to pay particular attention to credit for speculative sectors and/or possible weak-repayment-capacity borrowers. As at the third quarter of 2015, lending to the trade and construction²⁶ sectors accounted for 34 percent and 20 percent of total credit, respectively. As a percentage of GDP, lending to the construction sector (including real estate and mortgages) has tripled over the past five years, from 4 percent in 2010 to 13 percent in 2015 (Figure S3). Persistently high credit growth also squeezes banks' liquidity. Banks' average liquidity ratio is, therefore, declining, and fell from 85 percent in the second quarter of 2014 to 80 percent in the fourth quarter of 2014.

To mitigate liquidity pressures, an inter-bank market was established by the authorities with the introduction of negotiable certificates of deposit in 2013. However, in the absence of government bond markets, this nascent inter-bank market, which is crucial for some banks that face liquidity shortages, remains highly dependent on trust and collaboration among banks to further expand and deepen. The establishment of a government bond market can benefit Cambodia in terms of better managing the Government's fiscal position, offering a wider range of investable financial products, better managing financial institutions' liquidity, and setting up yield benchmarks.

The overall solvency ratio, mainly Tier 1, remains healthy, as it is higher than the prudential requirement of 15 percent. The solvency ratio of the banking sector declined slightly to 21.50 percent in

Figure S3: Total credit to the construction sector (% of GDP) has tripled over the past five years.



Source: National Bank of Cambodia.

²⁵ 2010 Annual Reports, National Bank of Cambodia and 2015 Cambodia Microfinance Association (CMA)

²⁶ Consisting of the construction, real estate, and mortgage sectors.

the fourth quarter of 2014, from its peak in the second quarter of 2012. However, the financial condition of some banks seems to be less satisfactory. The concentrated banking system has resulted in the top five performing banks generating a return on equity (ROE) of over 25 percent, whereas the average ROE of the banking sector was 16 percent as at the end of 2014.²⁷

The rapid expansion of the banking system may entail some risks due to the reliance on foreign funding. In terms of overall risk status, Standard and Poor’s classification of the banking sector in Cambodia is in group “9” under its “Banking Industry and Country Risk Assessment”²⁸ dated December 24, 2015. The banking system receives increased foreign funding and is therefore exposed to greater volatility of international capital markets. Foreign bank entrants, many of them are small and mid-sized banks, have limited ability to mobilize domestic savings, and depend largely on injections of foreign funds. Nonetheless, over the past two years they have grown rapidly and now account for nearly 40 percent of all new lending. This triggered the introduction reserve requirements of 12.5 percent for foreign borrowing.

On the other hand, the reported level of non-performing loans remain stable at low levels. The current reported level of non-performing loans (NPL) in banks has hovered below 3 percent of total loans since the first quarter of 2011, and is not among the highest by international comparison.²⁹ The NBC has improved its supervisory oversight of credit risk by tightening the classification of NPL. However, more could be done by requiring banks to establish prudential treatment for restructured loans and strengthening reporting and disclosure requirements on NPLs. Table S1 below illustrates performance indicators of banks.

Table S1: Performance indicators of Cambodia’s banks

Indicator (%)	1Q2013	2Q2013	3Q2013	4Q2013	1Q2014	2Q2014	3Q2014	4Q2014	3Q2015
Total loans expansion (year-on-year growth)	32.11	31.97	31.96	25.58	29.43	22.90	27.30	27.00	31.8
Total loans to GDP ratio	40.40	43.08	47.39	47.74	50.26	50.42	53.40	56.71	N/A
Total customer loans to customer deposit ratio	86.46	90.46	104.05	97.24	97.75	90.68	92.96	95.86	N/A
NPLs to total loans	2.31	2.52	2.55	2.70	2.59	2.63	2.56	2.22	N/A

Source: National Bank of Cambodia.

c) Microfinance sector

Microfinance institutions (MFI) have played a very important role, providing access to finance to a mostly rural population that would otherwise have to rely on unregulated private money lenders. The relatively nascent microfinance sector is experiencing explosive growth (Figure S4). The 34 microfinance institutions and seven micro-deposit-taking institutions (MDI), accelerated their credit growth to 46 percent year-on-year in 2015, and reached a record high of US\$2.9 billion outstanding loans, catering to 2 million borrowers, compared with only US\$426 million and 0.9 million borrowers at the end of 2010.³⁰ MFI performance has been remarkable, with an average return on equity (ROE) of 22 percent, and continued rapid lending growth.

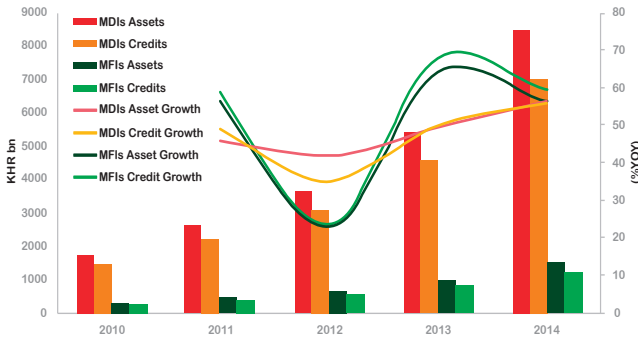
²⁷ Another nine banks earned more than 10 percent and the remainder earned below this threshold.

²⁸ BICRA scores country’s economic and banking industry risks and ranks from 1 (low risk) to 10 (high risk). The economic risk includes economic resilience and imbalances resulted from high credit growth while the latter considers regulatory & supervision framework, competitive dynamics, and system-wide funding sources of the banking industry.

²⁹ According to IMF Financial Soundness Indicators, as at end-2015, the countries with highest level of non-performing loans relative to notably, Moldova 16.7%, Pakistan 12.5%, Macedonia (FYR) 11.2%, Kazakhstan 9.2%, and the Russian Federation 7.4%.

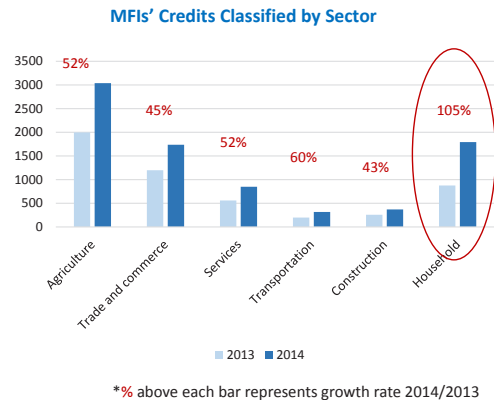
³⁰ 2011 Annual Report, the National Bank of Cambodia and 2015 Cambodia Microfinance Association (CMA).

Figure S4: MFI's growth has moderated while MDI's growth is on the gradual upward trend.



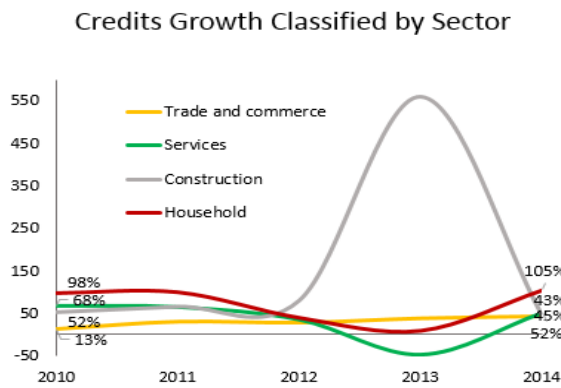
Source: NBC and Cambodia Microfinance Association

Figure S5. MFI credit has grown rapidly in every economic sector.



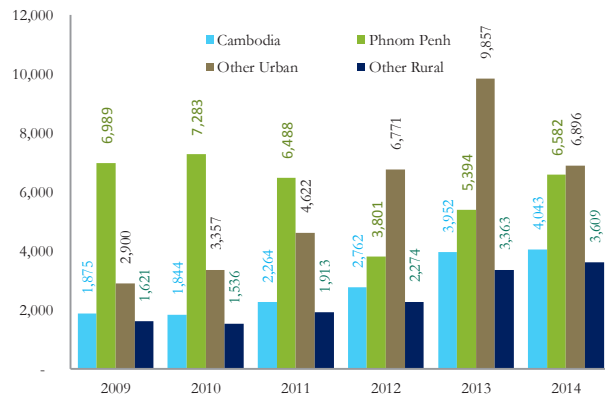
Source: National Bank of Cambodia and Cambodia Microfinance Association.

Figure S6: Credit growth was remarkable in the construction and household sectors.



Source: National Bank of Cambodia and Cambodia Microfinance Association

Figure S7: Average amount of outstanding credit by geographical domain. ('000 riels)



Source: 2014 Cambodia Socio-Economic Survey, NIS

The level of concentration of the microfinance sector is even higher than that of the banking sector. The top 12 Cambodian MFIs/MDIs account for 98 percent of the microfinance market by loan portfolios, and 97 percent by borrowers. Microfinance credit has grown rapidly in every economic sector (Figures S5 and S6). However, microfinance credit growth is uneven, with a few big players dominating.³¹ Meanwhile, MFIs' lending relative to bank lending grew from 16.2 percent in the first quarter of 2013 to over 20 percent in 2015. This reflects the more competitive growth strategy of MFIs compared with commercial banks, and probably the stronger preference for, and popularity of, MFI products compared with banks' products. Credit growth of MFIs was remarkable in the construction and household sectors.

This rapid MFI expansion has the potential to quickly improve access to finance, in particular for the rural population. The expansion, however, contributes partly to the trend towards multiple loan-taking that correlates with non-repayment among borrowers. The 2014 Cambodia Socio-Economic Survey found increasing amounts of outstanding credit per household, in particular for rural households, while outstanding

³¹ According to MIX Market research.

credit owed by Phnom Penh households remained stable (Figure S7). A recent study by Oikocredit in November 2015 highlights the likelihood of increasing multiple loans in Cambodia, suggesting a trend towards consumer indebtedness that may not be sustainable. Furthermore, some micro-deposit-taking institutions show declining solvency over the past two years and are very close to the prudential threshold. This is happening in the context of no deposit protection scheme and rapid growth (45 percent in 2015) of the deposit base, which topped US\$1.3 billion from 1.4 million depositors. Indebtedness is rising, especially in rural areas, and the information gap remains a challenge in Cambodia.

d) Insurance sector

Cambodia's insurance sector is small but gradually expanding, with total premium revenues of US\$60 million in 2014. The majority of premium volume is from general insurance (property line) and life insurance. There is very little health insurance, which is usually offered by companies with foreign ownership and typically servicing foreign-owned corporates with operations in Cambodia. The largest insurer by premium volume holds a 45 percent market share, with a leading position in general insurance.

The new Insurance Law enacted in July 2014 initiated compulsory Motor Third-Party Liability Insurance (MTPL) and micro-insurance activities in Cambodia. In terms of MTPL, only a small number of vehicles are covered under MTPL, even though Cambodia has seen a surge in motorists in recent years, with an estimated 10 traffic fatalities occurring daily. In terms of micro-insurance, one of the leading micro-insurers, achieving considerable success in a two-province pilot project, has rolled out nationwide micro-insurance cover for death, accidental injury, and salary-replacement during hospitalization treatment. The product's strength lies in its simplicity, which enables easy sales with very basic information to widespread lower-income markets. While the new law has undoubtedly opened up new opportunities in Cambodia, the general challenges in the insurance sector remain to be addressed. For example, there are limited long-term investment instruments for insurers to manage their assets and liabilities. In addition, the risk-based supervisory practices need to be further enhanced.

e) Cambodia securities exchange, market infrastructure, anti-money laundering and reporting

The newly established stock market has a low trading volume.³² Trading on the new stock exchange is thin, having as it does only three listed companies, which limits the scope for portfolio and risk diversification by individual investors. Capital raised through the capital market remains modest, standing at 0.2 percent of GDP, and market capitalization was 0.86 percent of GDP as at March 1, 2016. The Cambodia Securities Exchange (CSX) index peaked on April 20, 2012 at 1,096.77, with trading volume of 488,000 shares, but the index closed at only 390.73 on March 2, 2016, with trading volume of just 8,759 shares.

The information infrastructure for lending has been improved markedly, commensurate with the rapid expansion of the financial sector. The successful introduction of a private credit bureau,³³ the Credit Bureau of Cambodia (CBC),³⁴ with which all banks and MFIs must participate, underpins the improvement in coordination and strengthened supervision. As of April 2015, the CBC covered 4.2 million individuals,³⁵ including both positive and negative credit information, which licensed banks and MFIs are required to share, and to check with in the process of credit decisions. As a result, banks and MFIs have reported

³² The Cambodia Securities Exchange Co. Ltd. (CSX) was launched on April 18, 2012.

³³ A Prakas on Credit Information System was adopted in 2011, and with a joint investment from some of the banks, the MFI association, and a New Zealand-based technology company, together with IFC technical cooperation, the first private bureau was launched.

³⁴ Credit Bureau Cambodia was launched in March 2012.

³⁵ This number covers closed, active, and inquired borrowers.

substantial improvements in credit quality since participating in the CBC, for example by reducing their exposure to borrowers with multiple loans.

Cambodia was taken off the list of countries subject to the Financial Action Task Force's (FATF) monitoring process under its ongoing global Anti-Money Laundering (AML) and Combatting the Financing of Terrorism (CFT) compliance process. Following a review of compliance with AML and CFT standards, in February 2015, FATF observed significant progress in Cambodia's AML/CFT regime and noted that Cambodia had established the legal and regulatory framework to meet its commitments in its action plan.³⁶

Cambodia's dynamic enterprise sector has spurred growth in accounting and auditing activities in the past 10 years, albeit from a very low base. According to the National Accounting Council (NAC),³⁷ since 2010 all public-interest entities should be reporting in line with International Financial Reporting Standards (IFRS),³⁸ and other non-financial enterprises according to IFRS for Small and Medium-Sized Enterprises (SMEs), a simpler financial reporting standard. The 2010 Financial Sector Assessment Program (FSAP) highlighted some weaknesses in the accounting and auditing framework in Cambodia. It emphasized the importance of improving the quality of data from financial institutions to enable the appropriate assessment of risks and to implement a strategic plan for transition to IFRS.³⁹

f) Key messages

Authorities have recently introduced some important measures aimed at improving the resilience of the financial sector. The implementation of the recent directive (Prakas) of March 22, 2016, on minimum registered capital of banking and financial institutions issued by the NBC is key to further strengthen the banking sector including microfinance. This will encourage consolidation and mergers in the banking sector.⁴⁰ The recent introduction of reserve requirements of 12.5 percent for foreign borrowing and the liquidity coverage ratio will also support the strengthening of the banking sector. Other recent Prakas regulate home-host relations related to information-sharing, as well as emergency liquidity assistance (ELA).

Additional measures that could help further to improve supervision and information exchange in the short and medium term include the following:

- (i) **Refining data collection.** It is advisable to implement more conservative prudential treatment for restructured or re-scheduled loans and NPLs in each economic sector, large exposures, related-party exposures, banks' top-20 exposures, and country-risk exposures. It would be beneficial to improve the analytical tools by recommending clarification of the provisions coverage ratio, the large exposure ratio and the liquidity ratio, and improved approaches to system-level analyzes.

³⁶ Nevertheless, the Government of Cambodia continues to work with the Asia Pacific Group in ongoing efforts to address the full range of AML/CFT issues identified in its mutual evaluation report. In addition, the NBC is conducting a self-assessment of Money Laundering and Terrorist Financing (ML/FT) risks under the National Risk Assessment (NRA) process.

³⁷ The National Accounting Council (NAC) within the MEF is the standard-setting body for the profession, and the Law of Corporate Accounts (2002) established the legal framework for national standards of accounting.

³⁸ The definition of public-interest enterprise, however, is not fully understood, and the implementation has been weak.

³⁹ The authorities plan on the phased introduction of IFRS by financial institutions, and are considering revisions to the prudential regulatory framework and amendments to prudential regulations and financial reporting and external audit requirements to ensure alignment with IFRS.

⁴⁰ Since the framework for mergers is not well formed in Cambodia, the implementation of new capital requirements would need to be managed carefully to maintain confidence in the system.

(ii) Ensuring that loan classification is consistently applied from bank to bank, while the existing rules allowing for immediate upward reclassification of restructured loans could be reviewed. These tasks can be done within a short-term timeframe.

(iii) Revising the formula for calculating banks' liquidity to capture the time dimension. It is advisable to improve the analysis of liquidity risk by re-examining the ratio indicator to include only highly-liquid assets, by working with financial institutions to improve asset classification. It is advised to monitor potential risks, such as the emergence of non-resident loans and deposits in the banking system.

(iv) Additional prudential measures could instill further stability to the sector in the medium run. As banks have increased their concentration and increasingly rely on foreign funding they may be adding to systemic risks. This may be the case, in particular, for the banks that represent a large share of retail, corporate and inter-bank deposits. There is also a suspected large and increasing volume of "shadow-bank" lending to the construction and real estate sector. Therefore, further tools to moderate credit risk, such as required stricter loan-to-value ratios for collateralized lending to possible speculative businesses, would help to improve resilience. These tasks will likely require a medium-term timeframe to implement.

(v) Limitations on consumer lending relative to portfolio size may also be warranted, to rein in possible overheating in the consumer credit market. In this regard, further attention to improving consumers' financial literacy, in particular for the rural population.

(vi) Further improving the credit information system by expanding the CBC to cover legal entities. In this regard, CBC is working with the Ministry of Commerce, which maintains a registry of some 500,000 enterprises, in order to link enterprise registration information to credit histories.

(vii) Further improving data quality and encouraging disclosure policy. Market confidence can be further improved by public disclosure of the financial performance of the financial sector. This can be done by improving accounting and auditing practices in the financial sector.

(viii) Conduct a high-level crisis simulation exercise. This exercise aims to create opportunities for the authorities to use their respective existing crisis-management arrangements in terms of legal instruments, operational framework, inter-agency and intra-agency information sharing and coordination arrangements, and communication with key stakeholders and the public.

The authorities are making efforts to close critical gaps in crisis preparedness and the country's crisis management framework, which are exacerbated by the dollarized structure of the economy and financial system.⁴¹ The work to enhance the crisis management framework complements an expert review of the National Bank of Cambodia Law and the Law on Banking and Financial Institutions, and drafted amendments that provide, among other things, for the NBC's ability to carry out bank resolution for systemic and non-systemic banks. It is also recommended to set up a Committee for Financial Stability,⁴²

⁴¹ In February 2014, the NBC, the MEF, and the SECC signed a Memorandum of Understanding (MOU) on establishing a policy level Working Group (WG), which also led to the formation of a technical Core Team.

⁴² The signing of an initial MOU among supervisory agencies enhanced cooperation at the policy and technical levels. However, collaboration among financial regulators can be further improved. It is also important to have a clear legal mandate for macro-prudential oversight, and to consider adopting the proposed law changes that would empower the NBC to carry out bank resolutions.

empowered to oversee financial stability and to deal with a systemic crisis.⁴³ Given the time-consuming process of amending laws, this would need to be a medium-term action.

For medium to long term, the authorities plan to update the 2011 Financial Sector Development Strategy (FSDS) taking into account the 2010 Financial Sector Assessment Program (FSAP). The authorities may consider using the updated/revised FSDS as the basis for deciding future direction with the aim of building a functioning financial sector, supporting future economic developments for the next 5-10 years. This would guide policy direction to enhance the following practices, in line with international standards: regulatory and supervisory framework including insolvency regime, crisis management practice, data quality, disclosure policy, corporate governance, risk management practices, accounting and auditing practices, and consumer protection. In addition, the revised FSDS may address the high dollarization, asset-liability mismatches both in terms of currency and maturity mismatches, limited financial instruments, and more.

⁴³ The committee may be co-chaired by the NBC and the MEF.

Cambodia: Key Indicators

	2012	2013	2014	2015e	2016p	2017f	2018f
Output, Domestic Demand and Prices							
Real GDP (% change yoy)	7.3	7.4	7.1	7.0	6.9	6.8	6.8
Domestic demand (% change yoy)	9.9	11.3	10.1	12.6	10.7	11.1	12.5
Consumer price index (cop, % change yoy)	2.5	4.6	1.2	2.8	3.0	3.5	3.8
Public Sector (% of GDP)							
Government revenues	15.3	15.1	18.0	17.5	17.5	17.5	17.0
Government expenditures	21.0	21.5	21.5	20.5	22.3	22.0	22.5
Government balance excluding grants a/	-5.9	-6.6	-3.8	-3.0	-4.8	-4.5	-5.5
Government balance including grants a/	-3.3	-2.7	-1.4	-0.8	-2.8	-2.9	-4.1
Foreign Trade, BOP and External Debt							
Trade balance (US\$ million)	-2,455.7	-2,598.4	-3,213.0	-3,217.1	-3,301.7	-3,552.6	-3,693.3
Exports of goods (US\$ million)	5,632.8	6,890.2	7,408.4	8,519.6	9,550.0	10,520.0	11,830.0
(% change yoy)	7.9	22.3	7.5	15.0	12.1	10.2	12.5
Key export (% change yoy) 1/	7.0	17.6	11.7	14.5	14.0	14.0	14.0
Imports of goods (US\$ million)	8,088.5	9,488.6	10,621.4	11,736.7	12,851.7	14,072.6	15,523.3
(% change yoy)	20.6	17.3	11.9	10.5	9.5	9.5	10.3
Current account balance (US\$ million) 2/	-1,376.0	-1,378.1	-1,969.9	-1,984.9	-1,884.3	-1,999.2	-2,332.7
(% GDP)	-9.7	-9.0	-11.9	-10.8	-9.3	-9.3	-10.0
Foreign direct investment (US\$ million)	1,697.9	1,826.1	1,676.9	1,802.7	1,652.9	1,747.7	1,780.0
External debt (US\$ million)	4,547.4	5,110.7	5,555.4	6,020.0	6,469.3	6,894.5	7,343.0
(% GDP)	32.1	33.3	33.4	32.8	32.0	32.2	31.6
Debt service ratio (% exports of g&s)	1.0	1.1	1.3	1.4	1.5	1.6	1.7
Foreign exchange reserves, gross (US\$ million)	3,463.0	3,642.5	4,657.9	5,672.1	6,398.7	6,847.7	7,258.9
(prospective months of imports of g&s)	3.7	3.5	4.1	4.5	4.7	4.6	4.1
Financial Markets							
Domestic credit (% change yoy)	29.6	28.6	28.4	27.0	25.8	25.0	24.5
Short-term interest rate (% p.a.)	11.6	11.3	11.5	11.7	12.0	11.8	11.5
Exchange rate (Riel/US\$, cop)	3,995.0	3,995.0	4,075.0	4,054.0	4,058.0	4,062.0	4,067.0
Real effective exchange rate (2010=100)	105.4	109.9	113.1	119.8	121.8	124.3	127.4
(% change yoy)	0.5	4.3	2.0	1.3	1.7	2.0	2.5
Memo: Nominal GDP (US\$ million)	14,188	15,362	16,623	18,363	20,190.7	21,412.1	23,243.7

Sources: National data sources, IMF, and World Bank staff estimates.

e = estimate; p = projection; and f = forecast.

a/Includes expenditure adjustments

1/Garments and footwear.

2/Excluding official transfers.



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