

MAINTAINING HIGH GROWTH

CAMBODIA ECONOMIC UPDATE

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DOLLARIZATION ISSUE: ADVANTAGES, DISADVANTAGES AND WAYS FORWARD



WORLD BANK GROUP

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MAINTAINING HIGH GROWTH

CAMBODIA ECONOMIC UPDATE

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Preface and Acknowledgements

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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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Executive Summary

Cambodia continues to enjoy robust growth, albeit at a slightly slower pace. Real growth in 2014 is estimated to have reached 7.0 percent. The garment sector, together with construction and services, in particular finance and real estate, continues to propel growth. However, there are signs of weaknesses in garment and agricultural production that are slightly slowing growth. Overall macroeconomic management remains appropriate. Fiscal consolidation continues with further improvements in revenue collection resulting from enhanced administration. Poverty continues to fall in Cambodia (poverty headcount rate in 2012 was 17.7 percent) although the pace of poverty reduction has declined significantly. Cambodia's real growth rate is expected to moderate to 6.9 percent in 2015 and 2016, as it confronts stronger competition in garment exports, continued weak agriculture sector growth, and softer growth in the tourism sector.

Recent developments

The garment sector continues to be one of Cambodia's main engines of growth. While continuing to grow, the garment sector has recently faced increased competition, arising from the continued appreciation of the US dollar, emergence of other low-wage regional competitors, in particular Myanmar, and the enduring impact of past labor market unrest on garment orders. Garment exports eased to a year-on-year growth rate of 9.2 percent in value terms and 11.2 percent in volume terms in 2014, compared with 17.6 percent and 13.4 percent in 2013, respectively. The construction sector remains resilient, supported by the return of business confidence with the restoration of domestic political stability. Tourist arrival growth softened with a year-on-year arrival growth rate of only 6.9 percent in 2014, compared with 17.5 percent in 2013. Cambodia's pro-poor agriculture sector, which had experienced exceptional growth

driven by crop production mainly of paddy rice until the past few years, has recently eased due primarily to depressed agricultural commodity prices and slow yield improvements.

The external position remains stable, supported by healthy foreign direct investment inflows, underpinning the overall macroeconomic stability. Due to decelerated exports, the current account deficit (excluding official transfers) is, however, estimated to have slightly widened to 11.2 percent of GDP in 2014, financed primarily by foreign direct investment concentrated in the tourism, garment and construction sectors. Gross international reserves reached a record high of US\$4.6 billion, or about 4 months of prospective imports, at the end of 2014.

Exchange rate targeting continues to support price stability. The targeting together with dollarization, however, is eroding the competitiveness of exports to the EU market.¹ As the US dollar has strengthened, so the Cambodian riel (CR) has followed suit, only depreciating slightly against the US dollar, with the riel versus the US dollar exchange rate reaching CR 4,075 at the end of 2014, compared with CR 3,995 at the end of 2013. The riel, however, has appreciated by 17 percent against the Euro since July 2014.

Inflation has eased significantly with continuing depressed food prices and the recent decline in oil prices. Inflation dropped to 1.2 percent year-on-year at the end of 2014, compared with 4.6 percent at the end of 2013. In the consumer price index basket, year-on-year price indices of key non-food sub-components such as housing, utilities, and transportation retreated into negative territory, while the index of the food sub-component eased further. Regional and other developing-country inflation remains benign.

¹ Exchange targeting requires the National Bank of Cambodia (NBC) to buy (or sell) US dollar to maintain Cambodian riel (CR) versus US dollar exchange rate pegged. As capital (US dollar) inflows increase (decrease), the

NBC injects (withdraws) riels by buying (selling) US dollars to maintain a riel versus dollar exchange rate of about CR 4,000. As a result, gross international reserves increase (decrease).

Financial deepening continues, supporting economic expansion as deposit and credit growth accelerated quickly in 2014. Private sector deposits reached US\$8.81 billion, or a 30.6 percent year-on-year increase, at the end of 2014, compared with US\$6.88 billion, or a 14.2 percent year-on-year increase, at the end of 2013. Driven largely by foreign currency deposits after the return of confidence in the banking system and the overall economy, broad money growth doubled, reaching 29.8 percent year-on-year by the end of 2014, compared with only 14.6 percent at the end of 2013. As a result, dollarization increased still further, with the share of foreign currency deposits in broad money rising to 82.6 percent by the end of 2014, up from 82.2 percent at the end of 2013. Partly fueled by the construction boom, credit growth, which decelerated during the first half of 2014, once again picked up in the second half, reaching 31.3 percent year-on-year at the end of 2014 with an outstanding credit amount of US\$8.89 billion. As a result, the loan-to-deposit ratio rose to 87.2 percent at the end of 2014, up from 82.2 percent in mid-2014, but down from the 90 percent seen at the end of 2013.

Fiscal consolidation continues, with improved collection providing additional finances for rising public sector wages and priority spending without undermining macroeconomic stability. Thanks to the public financial management reform program, domestic revenue collection has accelerated further and is estimated to have reached 16.1 percent of GDP in 2014, compared with 15.1 percent collected in 2013. Expenditure remains contained, budgeted at 20.5 percent of GDP. The overall fiscal deficit (including grants), however, has only slightly improved and reached 2.5 percent of GDP because of a dwindling grants component, compared with 2.7 percent of GDP in 2013. Government deposits, therefore, rose to US\$1.1 billion at the end of 2014, compared with US\$700 million at the end of 2013, providing an increased

fiscal buffer against shocks. Cambodia's debt distress rating, as assessed by the joint World Bank/IMF debt sustainability analysis (DSA) conducted in 2013, remains low. Public debt to GDP ratio is estimated to have reached 33.9 percent by the end of 2014.

Overall, growth has been pro-poor in the recent past. Poverty has continued to fall. As of 2012, the poverty headcount rate (according to the national poverty line) was 17.7 percent, almost 3 percentage points lower than in 2011.² Growth disproportionately benefited households with lower incomes. Consumption in the bottom 40 percent of the consumption distribution grew at an average annual rate of 7 percent during 2007-12, compared with a 3.6 percent rate for consumption of the total population. This was mainly the result of a dynamic agriculture sector. Inequality has declined significantly, with the Gini coefficient falling from 32 in 2008 to 28 in 2012. Nonetheless, progress in reducing poverty and inequality has slowed in the past few years.

Outlook

The outlook for growth remains favorable with the return of confidence. The sharp decline in oil prices will help to contain production costs and improve the country's current account position. Cambodia is projected to gain about 0.5 percent in additional GDP this year from the oil price decline. GDP growth is projected to slightly moderate to 6.9 percent in 2015 due to softer growth of the key economic engines. Although vibrant activity in the construction sector is expected to continue, signs of weakness in the garment and agriculture sectors are likely to remain. Increased costs, US dollar appreciation, and new competitors, will likely continue to affect garment export growth. Due to dampened agricultural commodity prices in the international market and continued slow crop yield improvements, agriculture sector growth will likely be modest.

² The national poverty line for 2012 is CR 4,654.7 (nominal terms).

There are downside risks to forecast growth. These include on the domestic side, potential renewed labor unrest. On the external front, risks include a delay in economic recovery in Europe, and the reentry of Thailand and Myanmar into the international rice export market, together with the expected lower rice import demand coming from the Philippines and Indonesia, and potential regional political uncertainty.

In the next few years, rural poverty is likely to decline at a slower rate than in the past. In rural areas, further poverty reduction will be made more challenging due to slow crop yield improvement and reduced international agricultural commodity prices.

It is likely that inequality will not decrease in the near future. The projected sources of economic growth in the short and medium term, mainly the construction, garment and tourism sectors, are unlikely to favor the poor disproportionately.

Emerging Challenges and Recommendations

The key challenge will be to stimulate the agriculture, garment, and tourism sectors to boost economic growth and reduce poverty further.

Revitalizing garment sector growth in particular, as well as growth in the manufacturing sector more generally, will be instrumental in maintaining high growth and macroeconomic stability. This can be achieved in the short- to medium-term timeframe. First, to further strengthen and diversify exports, it will be vital to maintain stability in the labor market to benefit from relocation of industry from China. Second, it will be important to improve the business environment through the simplification and automation of business registration and trade facilitation processes, and the development of an enhanced investment law (see World Bank Investment Climate Assessment 2014). Finally, from a medium-term perspective, addressing the high cost of electricity by speeding up the

incorporation of additional power supply from hydro and coal-fired power plants, making efficiency improvements, and fostering transparency in solicitation in power distribution and supply provision would also be positive.

Given land area constraints, rice production growth—which had been driven largely by cultivated area expansion—will depend more on increases in rice yield and quality. Successes in revitalizing pro-poor agriculture growth will likely be obtained mostly in the medium-term due largely to continued dampened agriculture commodity prices, while the supply response may also take time. First, reducing logistics costs (with the establishment of a Logistics Task Force for Inter-ministerial Coordination) and doing business costs (to help address the main reasons for Cambodian rice losing the competitiveness it has at farm gate prices) can be done in a relatively short time with a strong commitment. Second, further improvements are needed in access to finance for rice producers and millers to increase milling volumes and reduce milling costs, which will require short- to medium-term response times. Finally, increasing public investment in agricultural advisory services, seed development and irrigation infrastructure to enhance shock resilience, and the opening up of new markets will have high impact but will be relatively time consuming and resource intensive. Detailed recommendations can be found in the forthcoming World Bank study “Agriculture in Transition”.

To improve tourism sector growth, efforts could be made to increase the time and money spent by tourists in Cambodia. This could be done by improving road transportation (linking borders, Siem Reap, key coastal areas and Phnom Penh), together with greater investment and coordination of efforts between central and local governments, the private sector, and local communities. Such efforts would all help to promote the diversification of tourist destinations beyond the Angkor Archeological Park. Promotion of regional tourist destinations and travel arrangements would also help capture a

larger share of the world tourism market which is growing.

Safeguarding stability in the rapidly expanding financial sector will help to ensure sustainable economic growth. Enhanced banking supervision in the nascent but rapidly expanding financial sector will help to prevent bubbles developing in the construction and real estate sectors, while also strengthening the country's resilience to possible higher volatility in international financial markets. With strong inter-ministerial coordination and commitment, successes in this area can be obtained over the short term as the technical and managerial capacity of the monetary and economic authorities has been improved after years of continuing successful performance.

Cambodia will greatly benefit from further improved investments and spending efficiency in health, education and social protection, translating into significant productivity and welfare gains in both the short and long run. Although the country has seen major improvements in terms of coverage, low education attainment and malnutrition are more prevalent among the poor population. Despite Cambodia's remarkable progress in poverty reduction, most households that have escaped poverty have done so only by a small margin and remain 'near-poor', leaving them highly vulnerable. Recent initiatives with the introduction and funding of health equity and

retirement funds are steps in the right direction. However, a better understanding of the coping mechanisms available for vulnerable households and their effectiveness would help to mitigate the risk of them falling back into poverty.

Further broadening of the tax base and strengthening of tax administration will help to improve collection, which is required to finance much needed development spending. Meanwhile, the rapidly rising wage bill will need close monitoring. Increased public investment to strengthen the agriculture and tourism sectors, as well as to support overall structural reforms discussed earlier, requires enhanced efficiency in public spending and additional financial resources. It will therefore be important to continue improving domestic revenue collection by further broadening the tax base and strengthening tax administration. Improvements in revenue collection continue to be made almost continuously, and therefore, it is important to keep up the efforts to further improve administration and good governance. While the rising wage bill clearly helps to improve the living conditions of poorly paid civil servants, wage rises alone will not be sufficient to improve service delivery. It will therefore be important to closely link pay increases with improved human resource management and performance outcomes. Furthermore, wage increases will require close monitoring in order to ensure that they remain affordable.

Recent Economic Developments

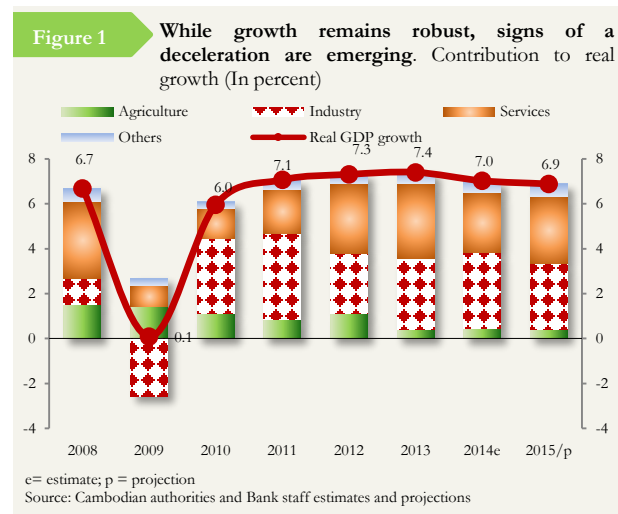
1. Real sector

1. Cambodia continues to enjoy robust growth, albeit at a slightly slower pace. Real growth in 2014 is estimated to have reached 7.0 percent (Figure 1). Garment exports continue to be one of Cambodia's main engines of growth. While continuing to grow and attract additional investments, the garment sector is confronting several challenges, including the continued appreciation of the US dollar, the emergence of other low wage regional competitors, in particular Myanmar,³ and the enduring impact of past labor market unrest on garment orders. Garment exports eased to a year-on-year growth rate of 9.2 percent in value terms and 11.2 percent in volume terms in 2014, compared with 17.6 percent and 13.4 percent in 2013, respectively. The construction sector remains resilient, supported by the return of business confidence with the restoration of domestic political stability. Cambodia's tourist arrivals decelerated with a year-on-year arrival growth rate of only 6.9 percent in 2014, compared with 17.5 percent in 2013. The agriculture sector, which experienced exceptional growth, driven by crop production, mainly of paddy rice until the last few years, has recently eased due primarily to depressed agriculture commodity prices and slow yield improvements.

2. The outlook for growth remains favorable with the return of confidence. The sharp decline in oil prices will help contain production costs, increase consumers' disposable income, and improve the country's current account position. Cambodia is projected to gain about 0.5 percent of GDP⁴ this year from the oil price decline. The country is also expected to graduate to lower-middle income status, see Box 1. However, GDP growth is projected to slightly

moderate to 6.9 percent in 2015 due to softer growth of some key economic engines. Although vibrant activity in the construction sector is expected to continue and the tourism sector is likely to partially recover, this may still be insufficient to offset the decelerating garment and agriculture sectors, resulting in slightly moderated growth. Increased production costs, US dollar appreciation and new competitors, will continue to affect garment export growth. Agriculture sector growth will likely continue to be modest, affected by dampened agricultural commodity prices in the international market and slow crop yield improvements.

3. There are downside risks to forecast growth. These include on the domestic side, potential renewed labor unrest. On the external front, the risks are a delay in economic recovery in Europe, and the reentry of Thailand and Myanmar into the international rice export market, together with the expected lower rice import demand coming from the Philippines and Indonesia, and potential regional political uncertainty.



³ Based on an analysis of garment exports and production in the first half of 2014, Myanmar is currently on track to export US\$1.7 billion in garment products over the course of 2014. This represents a near doubling of garment product export revenue in just two years. Garment exports

brought in about US\$1.2 billion in 2013 and just over US\$900 million in 2012.

⁴ East Asia and Pacific Economic Update, the World Bank, April 2015.

Cambodia is on track to become a lower-middle income economy by 2015

The World Bank classifies economies based on their **Gross National Income (GNI) per capita**. GNI is the total value of goods and services produced within a country (i.e., its GDP) plus the income received from other countries (notably from repatriation of profits and wages) less similar payments made to other countries earned in the domestic economy. For example, if a Cambodian company operating in a foreign country sends some of its profits back to Cambodia, this increases Cambodia's GNI. GNI is considered to be the best single indicator of economic capacity and progress, although it is recognized that GNI does not, by itself, measure welfare or success in development. GNI per capita is thus the World Bank's main criterion for classifying countries into income groups.

For the period **July 1, 2014 to June 30, 2015**, the World Bank has established a set of **income group thresholds** (Table B1.1). Low-income economies are those with a GNI per capita (calculated using the Atlas Method) of US\$1,045 or less in 2013; lower-middle-income economies are those with a GNI per capita of more than US\$1,045 but less than US\$4,125; upper-middle-income economies are those with a GNI per capita of more than US\$4,125 but less than US\$12,746; and high-income economies are those with a GNI per capita of US\$12,746 or more. The per capita income thresholds are updated the first of July every year to incorporate the effect of international inflation.

Table B1.1 Gross National Income per capita thresholds for income group classification as of July 2014 (in constant US\$ of 2013):

	Low income	< \$1,045
\$1,045 <	Lower middle income	< \$4,125
\$4,125 <	upper middle income	< \$12,746
\$12,746 <	high income	

Source: <http://data.worldbank.org/news/2015-country-classifications?print>
 Note: The thresholds are updated every July. For the latest thresholds see <http://data.worldbank.org/about/country-and-lending-groups>

As the thresholds remain constant over time in real terms, growth simulations need to be performed in constant 2013 US dollars. To assess the income grouping that Cambodia could belong to in the future, its economic growth is projected in constant 2013 US dollars and the resulting GNI per capita is compared with the thresholds presented in Table B3.1.

Cambodia's economy is likely to reach lower-middle income status in 2015, and this would be officially recorded in July 2016. At the forecast GDP growth in constant terms of 6.9 percent in 2015, and annual population growth of 1.2 percent, Cambodia will likely reach a GNI per capita of US\$1,096 (measured in constant 2013 US\$) in 2015, which exceeds the US\$1,045 threshold (Tables B1.1 and B1.2). As the World Bank updates income grouping membership in July, Cambodia's lower-middle income status would likely be officially recorded in July 2016.

Table B1.2 Simulation of dates and growth rates at which Cambodia would change its development status

GDP growth in constant US\$	GNI per capita in constant US dollars of 2013			
	2014	2015	2030	2050
4.9%	1,035	1,075	1,908	4,101
6.9%	1,035	1,096	2,589	8,148
9%	1,035	1,117	3,544	16,521

Source: World Bank staff calculations based on WDI, Atlas, and MEF data.

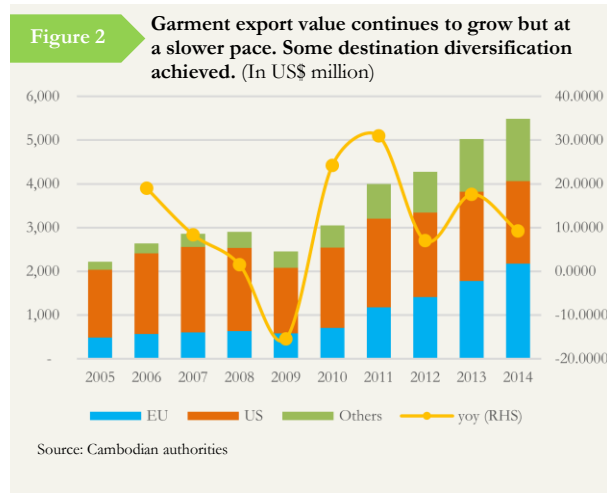
Note: Estimation is based on a Gross National Income of \$950 in 2013. Forecasted GDP growth is taken as a proxy for GNI growth. Annual population growth is assumed to be 1% per annum from 2015 onwards.

At the baseline growth scenario of 6.9 percent annual real GDP growth, Cambodia would reach upper-middle income status by 2039. Reaching high-income status by 2050 would require a real GDP growth rate of 9 percent (Table B1.2), which is equivalent to an 8 percent per capita income growth rate. Judging from countries' past growth experiences since 1950, maintaining such growth rate would require an extraordinary effort. The fastest growing countries over two decades reached average annual per capita income growth rates of 8.9 percent (China) and 6.1 percent (Armenia). However, attaining upper-middle income status before 2050 is well within reach if GDP growth exceeds the low case scenario of 4.9 percent. Under the baseline of 6.9 percent GDP growth, Cambodia would reach it already by 2039.

See <http://data.worldbank.org/indicator/NY.GNP.PCAP.CD> and <http://www.investordictionary.com/definition/gross-national-income>

a) Garments

4. **The value of garment exports continues to grow but at a slower pace, while there has also been diversification in export destinations** (Figure 2). The sector continues to attract additional investments although the labor unrest that the sector experienced in the past has been perceived as increased uncertainty in fulfilling orders, leading to a number of major brands diversifying their orders with other low wage competitors. In addition, there are some export destination diversification successes. In 2014, of the total US\$5.5 billion garment exports, US\$1.4 billion or 26 percent was destined for markets outside the US and the EU, compared with only 8.2 percent in 2005. The largest market share outside the EU and the US is Japan, which accounts for 6 percent. The share of garment exports to ASEAN remains low at just 1.3 percent. The strategy of exporting high-end garment products to the EU to benefit from the EU's Everything-But-Arms (EBA) preferential treatment continues, although it faces stiffer price competition due to the Euro's depreciation against the US dollar. Cambodian export prices, as well as input costs, are denominated in US dollars due to dollarization. In value terms, the share of garment exports to the EU has grown to 40 percent of total garment export value, while that of the US has shrunk further to 34 percent since 2014. In volume terms, the share of garment exports to the US has declined but remains the highest, at 44 percent of total garment export volume, while the EU share has risen to 36 percent.

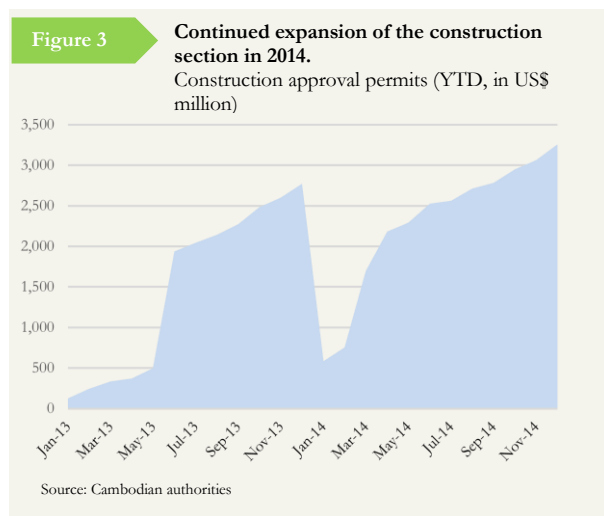


b) Construction and real estate

5. **The construction sector remains resilient, supported by the return of business confidence with the restoration of domestic political stability.** Construction sector activity remains vibrant, with real estate prices continuing to rise by up to 20 percent a year. Approved construction permits in 2014 reached US\$3.2 billion (Figure 3) or 17.5 percent higher than those issued in 2013.⁵ Half of the approved amount is for provincial construction projects. The value of real estate and tourism (fixed assets) projects approved by the Council for the Development of Cambodia (CDC) continues to grow, reaching US\$1.5 billion, or an 11 percent year-on-year increase, in 2014. However, occupancy is failing to keep up with the rapid pace of construction expansion. The expansion of the construction and services sectors against a backdrop of moderated real sector (tourism, garment, and agriculture) growth presents potential risks. Key risks associated with the continued expansion include: (i) the intrinsic cyclical nature of the construction and real estate sectors; (ii) the high FDI share makes the sector vulnerable if FDI recedes; (iii) speculative bubbles; and (iv) typical challenges facing land policy (transparent land management, resettlement management, etc.), which affect poverty efforts and shared prosperity. International experience shows that construction-

⁵ Change in investment approvals needs to be read with caution as they are very sensitive to any recent approval of a large project.

driven growth is volatile and less equitable, which suggests the desirability of guarding against an unsustainable construction boom.



c) Tourism

6. The tourism sector has experienced a slowdown. Cambodia's total tourist arrivals decelerated with total arrivals of 4.5 million, or a year-on-year arrival growth rate of only 6.9 percent in 2014, compared with total arrivals of 4.2 million, or a year-on-year arrival growth rate of 17.5 percent, in 2013, due largely to slower growth of arrivals from the two largest markets, Vietnam and China. Decelerated arrivals by land (40 percent of which was contributed by the Vietnam market), which account for about half of total arrivals, explain the moderated overall arrivals number, while a double-digit growth rate remains for arrivals by air (Table 1). Vietnam also experienced a sharp slowdown and Thailand faced negative growth in tourist arrivals in contrast to global tourism trends, which are anticipated to achieve record numbers.⁶

7. Tourism sector growth in 2014 was driven by arrivals from ASEAN countries and China. In 2014, while arrivals from Vietnam and

⁶ International tourism is set to hit a new record by the end of 2014 with over 1.1 billion international tourists travelling the world in one single year. UNWTO press release, December 2014.

⁷ About 95 percent of foreigners arriving in Cambodia report coming for tourism purposes.

China continued to capture the first- and second-largest shares, accounting for 20.1 percent and 12.4 percent of the total arrivals, respectively. Arrivals from the Republic of Korea (South Korea) eased and was overtaken by those from Lao PDR which contributed 10.2 percent of the total arrivals.⁷ Arrivals from Japan continued to grow but at a slower pace although Japanese investors' confidence in Cambodia remains upbeat.⁸

Table 1 In 2014, tourist arrivals to Cambodia and Vietnam decelerated while Thailand's arrival growth was negative.

	Cambodia		Thailand		Vietnam	
	2014	2013	2014	2013	2014	2013
Total arrival (in mln)	4.50	4.21	25.02	26.55	7.83	7.54
Change (y/y, %)	6.9%	17.5%	-6.1%	18.8%	3.8%	12.5%
o/w Air arrival (in mln)	2.27	2.02	15.52	15.37	6.22	5.98
Change (y/y, %)	12.7%	17.2%	1.0%	8.7%	3.9%	6.8%

Source: Cambodia's Ministry of Tourism, Tourism Authority of Thailand, Vietnam's Ministry of Culture, Sports, and Tourism

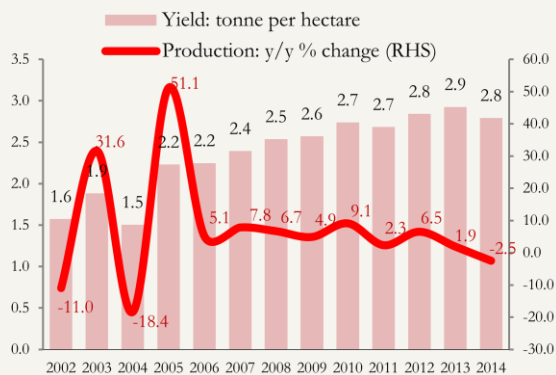
d) Agriculture

8. Cambodia's pro-poor agriculture sector, which had experienced exceptional growth driven by crop production mainly of paddy rice until the past few years, has recently eased due primarily to depressed agriculture commodity prices and slow yield improvements. Agriculture growth remains weak, as expansion of cultivated areas and yields, particularly in the case of rice, has slowed. In 2014, the wet season rice harvested area increased compared with that of 2013, although the cultivated area decreased slightly. Rice production and yield of the wet season, however, declined by 2.5 percent and 3 percent, respectively (Figure 4a). Rice prices also fell in 2014 (Figure 4b). Given the land area constraints, rice production growth—which had been driven largely by cultivated area expansion—will from now on depend more on improvements in rice yield. Agriculture prices are not expected to increase as international price

⁸ JETRO's 2014 Survey on Business Conditions of Japanese-Affiliated Firms in Asia and Oceania Japanese (http://www.jetro.go.jp/en/reports/survey/pdf/2015_01_biz.pdf).

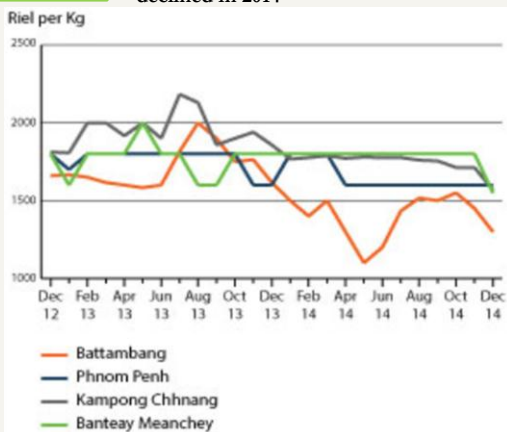
volatility for most commodities has now returned to historical norms. Global food prices gradually declined and the global rice market has become more competitive with the reentry of Thailand and Myanmar.

Figure 4a Wet season rice (production and yield) accounting for almost 80 percent of total rice production declined in 2014.



Source: Cambodian authorities

Figure 4b Wholesale rice prices in selected markets declined in 2014



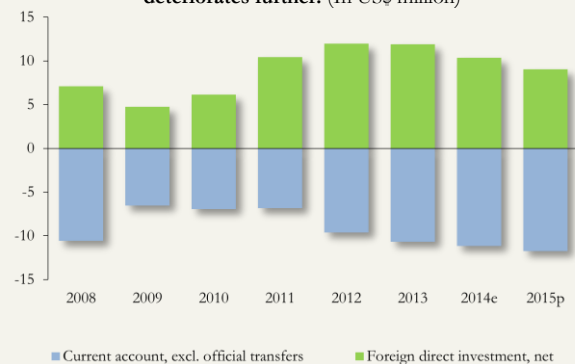
Source: FAO based on data from Cambodia Agricultural Market Information System. <http://www.fao.org/giews/countrybrief/country.jsp?code=KHM>

2. External sector

9. The external position remains stable, supported by healthy foreign direct investment inflows, underpinning the overall macroeconomic stability. The current account deficit (excluding official transfers) is estimated to have slightly widened to 11.2 percent of GDP in 2014, compared with 10.7 percent of GDP in

2013, and continues to be financed largely by FDI (Figure 5). FDI inflows continue, but are estimated to be below the 2013 level, attracted primarily by the tourism and construction sectors, while the garment sector also received a smaller boost. Gross international reserves (GIR) have improved, reaching a record high of US\$4.6 billion, or about 4 months of prospective imports,⁹ at the end of 2014.

Figure 5 As export growth decelerates more than offsetting slower import demand, trade deficit deteriorates further. (In US\$ million)



e= estimate; p = projection

Source: Cambodian authorities and World Bank staff estimates and projections

a) Exports

10. Export growth continues but at a slower pace due to a softer performance in the garment and footwear sectors (Figure 6). The value of other exports, mainly agricultural products, has been hampered by depressed commodity prices although the export volume rose. Although favorable external conditions continue, domestic pressures such as a tighter labor market and rising wages, as well as the appreciation of the US dollar with Cambodia's dollarized economy, may have already exerted, and may continue to exert, pressure on profit margins and sales in the garment sector (See Selected Issue on "Dollarization Issue: Advantages, Disadvantages, and Ways Forward")

⁹ Prospective imports of goods and services.

for the implications of dollarization, and see also Box 2 on the trade reforms that the Royal Government of Cambodia (RGC) is implementing to improve the business environment).¹⁰ Agricultural commodity exports, in particular rice and rubber, have been increasingly affected by dampened global agricultural commodity prices. In 2014, the total value of exports year-on-year in US dollar terms is estimated to have increased by about 10 percent, which is lower than the 22.3 percent seen in 2013.

b) Imports

11. Except in construction material imports, which were boosted by the booming construction sector, growth of most key imported goods moderated in 2014. Domestic demand during the second half of 2014 was softer than previously anticipated due to weaker overall real economy activity, with the exception of the booming construction sector. This led to lower import growth despite confidence in the economy being restored. Low oil prices will help contain imports in 2015, as Cambodia is an oil importing country.

Figure 6

As export growth decelerates more than offsetting slower import demand, trade deficit deteriorates further. (In US\$ million)



Source: Cambodian authorities and World Bank staff estimates and projections

¹⁰ Vietnam - European Union Free Trade Agree expected to be signed early this year further increases competition for the EU market which accounts for almost half of the entire Cambodia's export market.

Box 2

Cambodia's trade sector is reforming

The RGC's customs and border reforms initiated over the past decade have led to significant improvements.

Customs procedures are now done through computers at 21 border checkpoints. The time to clear customs has dropped from 5.9 days in 2010 down to 1.4 days in 2014. Physical inspections have fallen from 29 percent in 2010, to 17 percent in 2014. These improvements have contributed to Cambodia leaping in just four years 46 positions in the World Bank Logistics Performance Indicator (LPI), which ranks country's trade logistics systems.

Despite progress, there is still much work needed to improve Cambodia's trade costs and business environment. Cambodia's trade costs are around 40 percent higher than the regional average. Its business environment is less favorable to private sector development than in many other countries. Its ranking in the overall Ease of Doing Business of the World Bank Doing Business 2015 is 135th out of 189 countries, and its ranking in Starting a Business is almost bottom of the list, at 184th.

To address this, the RGC has initiated a new wave of reforms since early 2014. Three key reforms in the area of trade facilitation are:

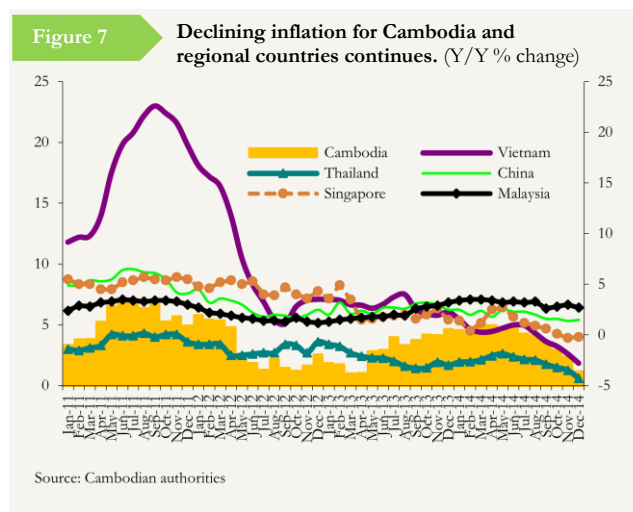
1. **Company registration is being simplified and automated.** It is intended to allow applicants to register a new company online in significantly less time, ultimately diminishing face-to-face contact.
2. **Automation of the Certificate of Country of Origin (COO).** In a first phase, the Ministry of Commerce launched an Interim System, which can be used from the Ministry's premises. Work is under way for the system to be fully automated so that companies can apply for the certificate electronically. The new COO system is intended to become an electronic payment platform and offer the first e-payment facility (with e-signature) for government services.
3. **Transition of CAMCONTROL to a modern Food Safety and Consumer Protection Agency.** This is intended to improve the overall level of food safety in Cambodia and reduce duplications with the General Department of Customs and Excise (GDCE).

The RGC has requested the private sector to help support efforts to reduce informal payments.

In response, 17 large companies have recently signed an MOU with the Anti-Corruption Unit, 9 of which are located in the Phnom Penh Special Economic Zone (PPSEZ).

3. Inflation

12. Inflation has eased significantly with continuing depressed food prices and the recent decline in oil prices. Inflation dropped to 1.2 percent year-on-year at the end of 2014, compared with 4.6 at the end of 2013 (Figure 7). In the consumer price index (CPI) basket, year-on-year price indices of the key non-food sub-components such as housing, utilities, and transportation, retreated into negative territory, while the price index of the food sub-component also further eased. Regional and other developing-country inflation has eased since the second quarter of 2014. The decline mainly reflects lower inflation in China in line with its slower growth. Depressed commodity prices have helped to ease inflation among low-income countries, while policy tightening has also contributed to subdued inflation. Food price risks related to El Niño weather conditions that had been anticipated in fact failed to materialize.

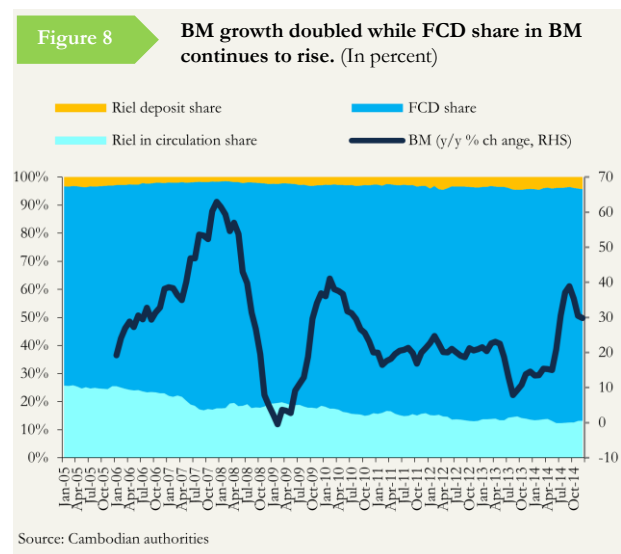


4. Monetary sector

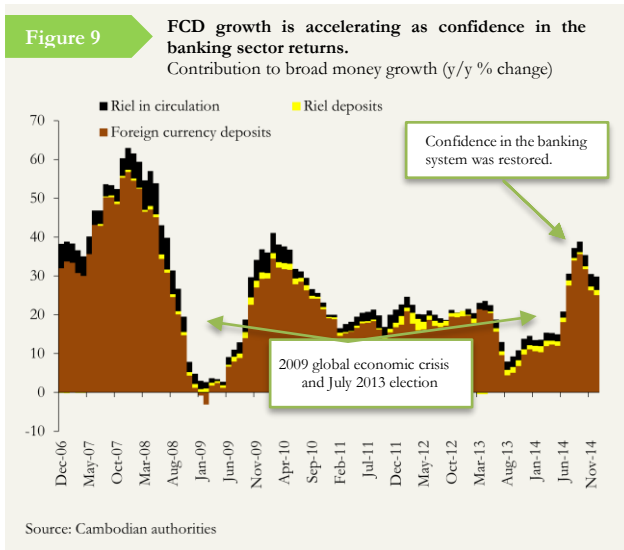
a) Monetary aggregates, interest rates, and exchange rates

13. As confidence returned, broad money growth picked up rapidly in 2014, strengthening the banking and financial sector. Broad money reached US\$10.4 billion or 62.9 percent of GDP at the end of 2014,

compared with US\$8.2 billion or 53.4 percent of GDP at the end of 2013. Broad money (BM) growth picked up rapidly in 2014 as confidence in the banking system returned. BM growth doubled, reaching 29.8 percent year-on-year at the end of 2014, compared with only 14.6 percent at the end of 2013 (Figure 8).



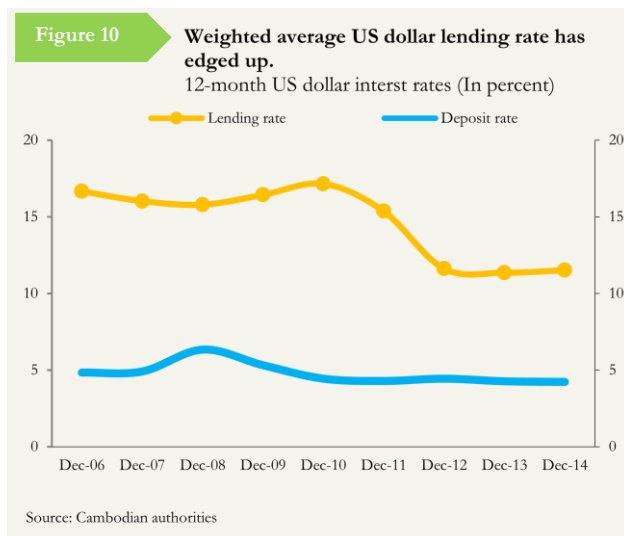
14. BM growth remains largely driven by foreign currency deposits (FCD). The share of FCDs in BM rose to 83 percent at the end of 2014, compared with 82 percent in 2013, reflecting increased dollarization. The role of the national currency, the riel, continues to be weak, undermining the conduct of monetary policy. See Selected Issue section for advantages and disadvantages of dollarization. Of the 29.8 percent BM growth rate, FCD contributes 25.1 percentage points, riel in circulation account for 3.5 percentage points, while riel deposits account for the remaining 1.3 percentage points (Figures 8 and 9).



15. **Gross international reserves reached a record high with healthy foreign direct investment inflows, supporting the central bank’s ability to stabilize the banking and financial sector.** Gross international reserves (GIR) rose to a record level of US\$4.6 billion, or about 4 months of imports, at the end of 2014. This further strengthens the central bank’s ability to support a current account deficit during external shocks that cause US dollar shortages. The current GIR level, however, remains low by regional standards (see Table 2) and covered only 53 percent of private sector deposits at the end of 2014, down from 103 percent at the end of 2005. The central bank’s ability to support a current account deficit, therefore, remains to be further improved. This is particularly so given the context in which the central bank cannot serve as the lender of last resort due to dollarization.

Table 2	Thailand	Indonesia	Malaysia	Philippines	Vietnam	Lao PDR
Gross international reserves						
In bln of US dollar	216.6	111.9	116.1	87.7	38.0	0.75
In months of prospective imports of goods and services	9.2	7.2	5.6	-	2.6	1.1

Source: Article IV staff reports, IMF (2013 and 2014)

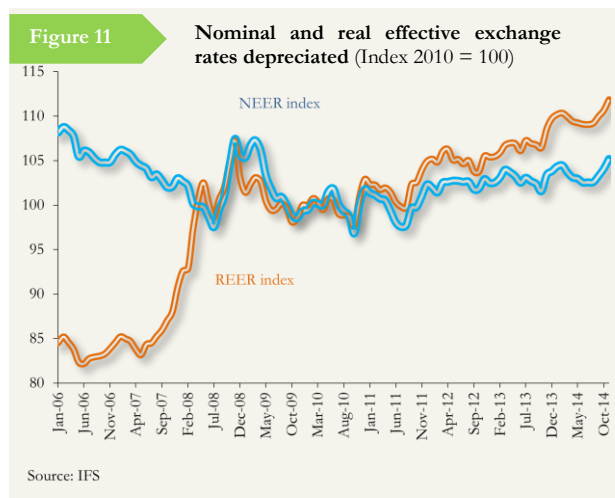


16. **The lending rate has edged up slightly as domestic credit growth has once again rapidly expanded.**¹¹ The domestic US dollar interest rate—the US dollar lending rate 12-month weighted average—increased to 11.51 percent per annum at the end of 2014, compared with 11.3 percent at the end of 2013 (Figure 10). The domestic US dollar fixed deposit interest rate (12-month weighted average), however, remains at 4.2 percent per annum. As a result of heightened competition among banks, the interest rate spread—the difference between the nominal lending rate and the deposit rate—shrank between 2010 and 2012, while nonetheless still remaining wide.

17. **Exchange rate targeting continues to broadly support price stability.** The Cambodian riel (CR) has hovered at around CR 4,000 per US dollar for several years now. As the US dollar has strengthened, so the riel has followed suit, only slightly depreciating against the US dollar from CR 3,995 per US dollar at the end of 2013 up to CR 4,075 per US dollar at the end of 2014. Exchange rate targeting—the pegging of the riel to the US dollar—however, does not encourage de-dollarization. Moreover, as regional currencies are depreciating against the US dollar, dollarization renders Cambodia’s exports less competitive in markets outside the US. However,

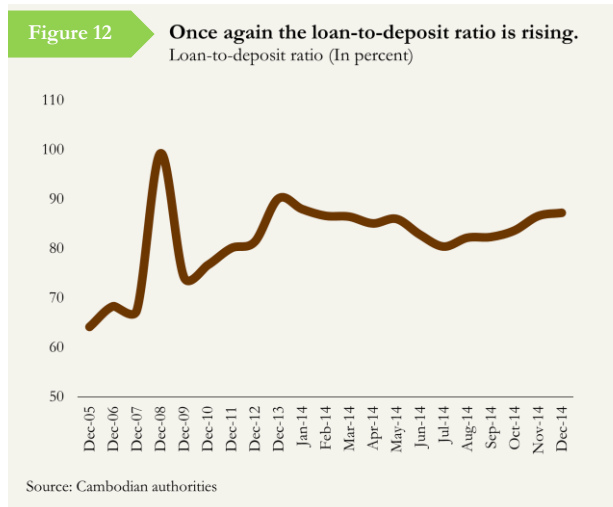
¹¹ US Federal Reserve ended its quantitative easing in October 2014.

the nominal effective exchange rate (NEER) and real effective exchange rate (REER) have depreciated slightly (Figure 11). The NEER index rose to 105.2 in November 2014 from 103.8 at the end of 2013, while the REER index also increased to 111.9 from 109.7 during the same period.

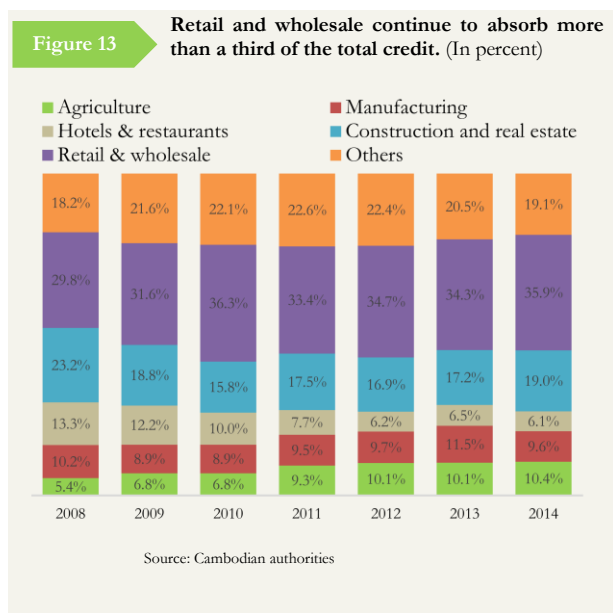


b) The banking sector

18. Financial deepening continues as deposit and credit growth accelerated quickly in 2014, increasing financial intermediation and supporting economic growth. Private sector deposits reached US\$8.81 billion, or a 30.6 percent year-on-year increase, at the end of 2014, compared with US\$6.88 billion, or a 14.2 percent year-on-year increase, at the end of 2013. Credit growth, which decelerated to 20 percent year-on-year during the first half of 2014, once again picked up, reaching 31.3 percent year-on-year at the end of 2014 with an outstanding credit amount of US\$8.89 billion. As a result, the loan-to-deposit ratio rose to 87.2 percent at the end of 2014, from 82.2 percent by mid-2014, but down from 90 percent at the end of 2013 (Figure 12).



19. The sectors capturing most of the recent credit expansion are retail, wholesale, construction, real estate, and agriculture. Underpinning the growing services sector, credit to wholesale and retail businesses expanded further, accounting for 35.9 percent of the total credit by October 2014, compared with only 34.3 percent at the end of 2013. The construction, real estate, and mortgage sectors absorbed 19.0 percent of the total credit, compared with only 17.2 percent at end-2013. Credit to the agriculture sector also increased, accounting for 10.4 percent of the total credit, rising from 10.1 percent in 2013 (Figure 13).



20. While having many banks helps to strengthen competition and underpin efficiency, the lack of scale creates low returns on capital for the majority of banks.¹² It is therefore important to further strengthen the stability of the financial sector through improved inter-agency coordination, strengthened supervision capacity, improved risk management practices in the banking sector and enhanced quality of banks' assets.

5. Fiscal sector

21. Fiscal consolidation continues as improved collection and contained spending help improve overall fiscal deficits and sustain macro-fiscal stability. Improved revenue provides additional resources to finance rising wage and priority spending. Thanks to the Public Financial Management Reform Program (PFMRP), domestic revenue collection has accelerated further and is estimated to have reached 16.1 percent of GDP in 2014, compared with 15.1 percent collected in 2013. Expenditure remains contained as budgeted at 20.5 percent of GDP. The overall fiscal deficit (including grants), however, has only slightly improved and reached 2.5 percent of GDP because of a dwindling grants component, compared with 2.7 percent of GDP in 2013.

a) Revenue composition

22. Total general government domestic revenue is estimated to have reached 16.1 percent of GDP, or US\$2.68 billion in 2014, thanks to improved revenue administration, creating increased fiscal space (Figure 14). This represents a 1.0 percentage point of GDP improvement, outperforming the target of 0.5 of a percentage point of GDP per annum increase set under PFMRP. To further strengthen revenue collection, the authorities have recently adopted a medium-term 2014-18 Revenue Mobilization Strategy (RMS) (see Box 3 for more details). The

¹² Cambodian banks: high growth opportunity versus low return on equity conundrum, Mekong Strategic Partners, November 2014.

Box 3

2014-18 Revenue Mobilization Strategy at a Glance

- **Main principles:** (1) full potential; (2) no new tax; (3) no tax rate increase; and (4) simplicity, equity, efficiency, transparency, and accountability.
- **Three pillars:** (1) revenue administration; (2) revenue policy; and (3) monitoring and evaluation.
- **Target:** 0.5 percentage point of GDP current revenue increase per annum.
- **Policy reviews:** excises, value-added tax, tax base (estimated regime category), tax incentive, and property tax. Studying income tax and drafting state property law.

Annual targets by general department

General department	2014b	2015p	2016p	2017p	2018p
(In percent of GDP)					
GDCE	6.85	7.08	7.24	7.39	7.54
<i>Change</i>		0.23	0.16	0.15	0.15
GDT	5.87	6.26	6.62	6.97	7.29
<i>Change</i>		0.39	0.36	0.35	0.32
Non-tax revenue	2.48	2.35	2.40	2.45	2.51
<i>Change</i>		-0.13	0.05	0.05	0.06
Total	15.20	15.69	16.26	16.81	17.34

GDCE: General Department of Customs and Excise

GDT: General Department of Taxation

b = budget; p = projection

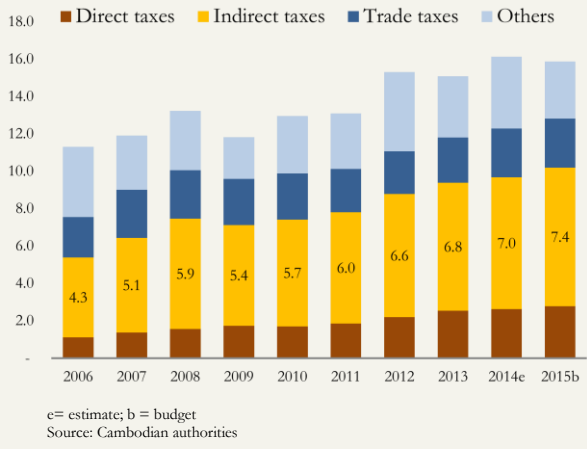
Areas of focus

General department	Measures or focused areas
GDCE	Automated manifest, risk management, post-clearance audit, anti-smuggling, single window, institution, human resources, and audit strengthening
GDT	Registration, services, tax audits, debt, organization, human resources, and technology
Non-tax revenue	Receipting system, civil aviation, tourism, visas, telecom, leases, public enterprises, casinos, and privatization

Source: Cambodian authorities

RMS is expected to address key weaknesses in revenue administration supporting the broadening of the tax base while maintaining existing taxes and tax rates.

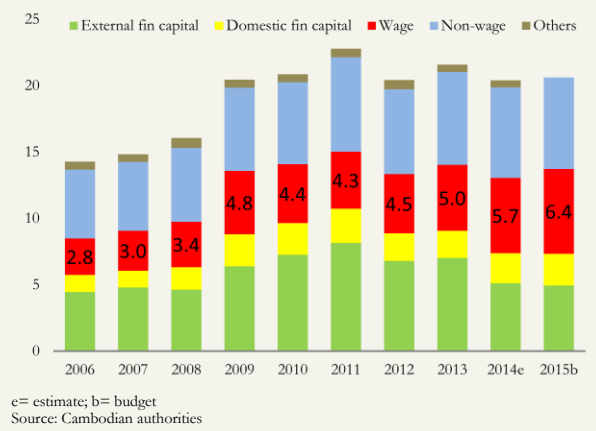
Figure 14 Domestic revenue is expanding, thanks to indirect taxes. (In percent of GDP)



b) Expenditure composition

23. Total general government spending is estimated to have remained in line with the budgeted 20.5 percent of GDP in 2014, or US\$3.4 billion, consolidating the authorities' fiscal position to strengthen fiscal buffer (Figure 15). This represents 1.0 percentage point of GDP below 2013 total spending of 21.5 percent of GDP. The authorities appear to be tightening spending, in particular capital expenditure, in the post-fiscal stimulus period as spending efficiency is further strengthened. Further broadening of the country's fiscal space, however, is potentially being constrained by a rapidly rising wage bill.

Figure 15 Rising wage bill while capital spending is constrained. (In percent of GDP)



c) Fiscal balance

24. Increased revenue collection helps to promote sustainable fiscal performance, while improved spending efficiency also strengthens public sector service delivery. The overall fiscal deficit (including grants) is estimated to have improved further, reaching 2.5 percent of GDP in 2014 compared with 2.7 percent of GDP in 2013 (Figure 16). The deficit continues to be financed by external funds (Figure 17). As a result, government deposits rose to US\$1.13 billion at the end of 2014, compared with US\$700 million at the end of 2013. Government deposits are crucial for Cambodia as they can be used as a fiscal stimulus to mitigate external shocks without resorting to additional borrowing. Note that, as explained in the monetary sector section above, the country's monetary policy is constrained by dollarization.

Figure 16 The overall fiscal deficit improved in 2014. (In percent of GDP)

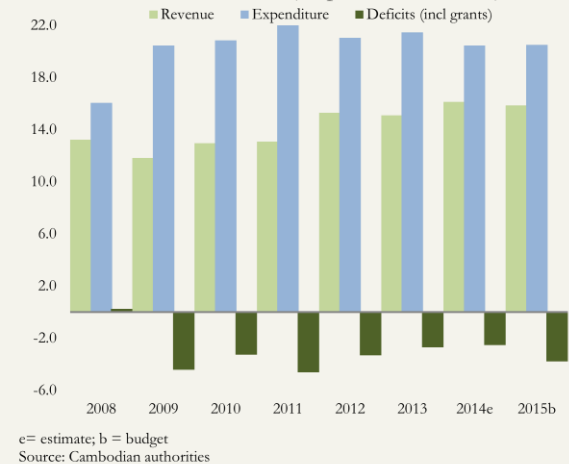
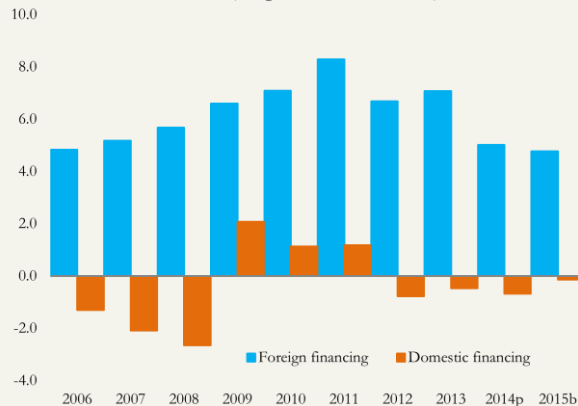


Figure 17 External funds continue to finance fiscal deficits. (In percent of GDP)



Source: Cambodian authorities

25. A joint World Bank/IMF debt sustainability analysis (DSA) conducted in 2013 showed that Cambodia’s debt distress rating remained low, with all debt burden indicators projected to remain below their respective thresholds.¹³ The size of Cambodia’s external debt (including arrears) is projected to have reached US\$ 5.6 billion or 33.9 percent of GDP in 2014.

Box 4

2015 Annual Budget and Budgetary Reforms

A number of key budgetary reforms have been introduced in the 2015 annual budget:

Government-financed or domestically financed budget for capital spending is now fully appropriated for all ministries. Up to 2014, capital budget appropriations were made for only four ministries: Water Resources and Meteorology; Rural Development; Public Works and Transport; and Land, Construction, and Urbanization. Unlike previous years, the full appropriation for 2015 does not leave any in-year discretionary budgetary decisions beyond sector ministries’ control, thereby improving capital budget allocation management and transparency.

Donor-financed or externally financed component is now budgeted for all ministries. Previously, due to fragmentation in budget management which separated donor-financed from government-financed components, ministries were not able to see a full “picture” of their budgets. The improvements introduced in the 2015 annual budget supports the implementation of the 2013-18 Budgetary Reform Strategy and are consistent with de-concentration of budget management for better linkages between annual budget and policy priorities as well as for accountability and results.

A long outstanding issue of large cash advances is being addressed. Cash advances were partly responsible for holding up end-year financial reports from being finalized timely and were therefore, delaying annual budget audits. The 2015 budget allocates CR 276,500 million (US\$69 million) to write off cash advances made between 2004 and 2014 so that a “clean” budget balance begins in 2015 for the implementation of the Financial Management Information System (FMIS). The Public Financial Management Reform Program (PFMRP) is helping reduce and ultimately eliminate large cash advances through streamlined commitment and payment processes.

The 2015 budget circular appropriately discusses key reform priorities. The prioritization for general administration is strengthening land management and judicial reforms; linking salary increase and payroll reform under the public administrative reform (PAR); and promoting cross-cutting areas under PFMRP, PAR; and anti-corruption. The social sector’s priorities include education quality, technical training, skills, health services, health equity funds, pension funds, and social safety nets. The economic sector’s priorities cover strengthening of the management of land concessions and national resources, improvement of tourism value addition, and expansion and maintenance of road and irrigation systems.

¹³ By the time of the writing of April 2015 Cambodia Economic Update, the new DSA exercise has not yet been conducted.

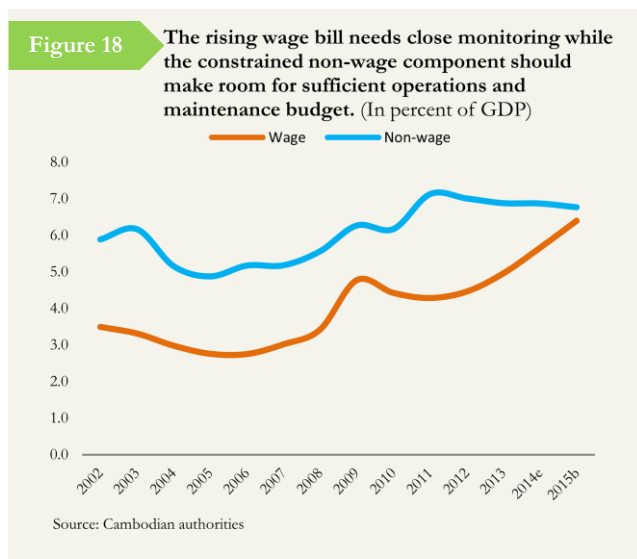
d) 2015 Budget

26. Budgetary reforms under the PFMRP have enhanced the linkages between the 2015 budget law and priorities. As a result, budget appropriation, integration, and transparency have markedly improved. Both domestically financed and externally financed budgets are fully appropriated for all line ministries, serving a complete budget integration and supporting the authorities' pursuance of program-based and result-based budgeting linked to national and sectoral strategies and priorities. The improvement also lays a solid foundation for a successful implementation of the Financial Management Information System (see Box 4 for more details).

27. In the 2015 budget, budgeted revenue can be further improved. A conservatively budgeted revenue target, together with a declining grants component, gives rise to an overall deficit (including grants) forecast at 3.8 percent of GDP in 2015, compared with 2.5 percent of GDP estimated for 2014 (Figure 16). The domestic revenue budgeted for the 2015 fiscal year, at 15.9 percent of GDP, appears conservative and slightly below the estimated collection of 16.1 percent of GDP in 2014. It is, however, higher than the 15.5 percent of GDP budgeted for in 2014. The 2015 budgeted revenue target continues to rely on indirect tax. Non-tax revenue of 1.97 percent of GDP budgeted for in 2015 is somehow lower than the target of 2.35 percent of GDP set in the Revenue Mobilization Strategy (RMS). Total general government spending is budgeted to remain at 20.5 percent of GDP in 2015. The budgeted fiscal deficit excluding grants has therefore slightly widened, budgeted at 4.6 percent of GDP in 2015, compared with 4.3 percent of GDP in 2014.

28. The rapidly rising wage bill will need to be closely monitored. With a target of having a minimum public sector wage of CR 1 million (or

US\$250 equivalent) a month by 2018, annual wage budget increases (Figure 18) need close monitoring.¹⁴ To achieve this target, some estimates put the annual total wage bill increase (civilian, security and defense) at up to 20 percent, well above the annual increase in domestic revenue of around 15 percent projected under RMS. The non-wage component continues to be compressed, having not risen as a percentage of GDP since 2011. It is, therefore, important to ensure that priority spending, including operations and maintenance budgets (under non-wage component), are adequately funded.

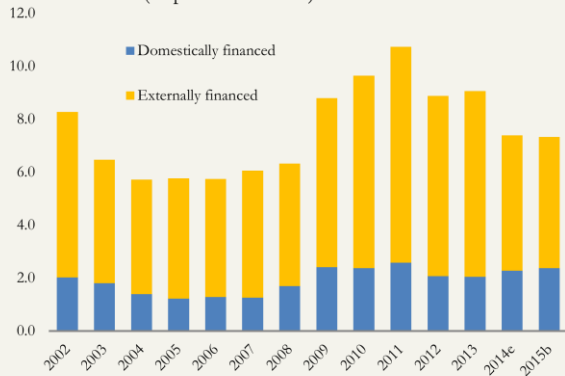


29. Given existing capital budget constraints, maintaining capital investment needs will only be possible with further improved spending efficiency and enhanced public investment quality control (Figure 19). To maintain public investments in sound condition, additional allocations for the operations and maintenance budget will be required. Stepping up quality control of public capital investments, in particular for infrastructure projects, will improve spending efficiency and promote savings, such as in the case of the pharmaceutical budget discussed below.

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

Figure 19

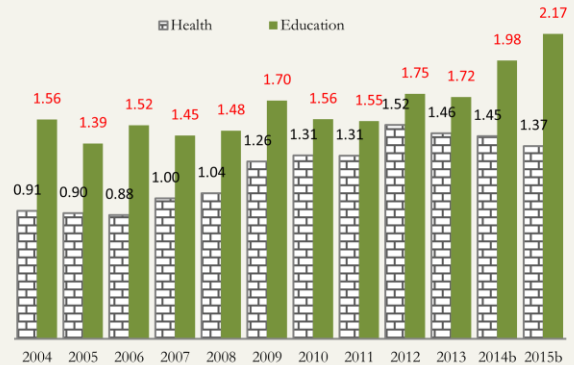
Capital spending is being contained as externally financed capital decreases.
(In percent of GDP)



Source: Cambodian authorities

Figure 20

Gov't financed spending for education ministry continues to improve. (In percent of GDP)



Source: Cambodian authorities

30. Social sector spending has notably improved on two fronts: increased allocations and improved efficiency. The education allocation rose to 2.17 percent of GDP in the 2015 budget, up from 1.97 percent of GDP in the 2014 budget (Figure 20). With 40 percent savings in the pharmaceutical budget stemming from improved procurement, the health allocation as a share of GDP declined to 1.37 percent of GDP in 2015 budget, down from 1.45 percent of GDP budgeted for 2014. The health budget increased in absolute terms, reaching CR 1,023 billion in 2015, up from CR 978 billion in 2014. The savings from the pharmaceutical budget will be used to fully finance health equity funds.

Box 5

Poverty trend measured under the international US\$ 1.25/day Purchasing Power Parity (PPP)

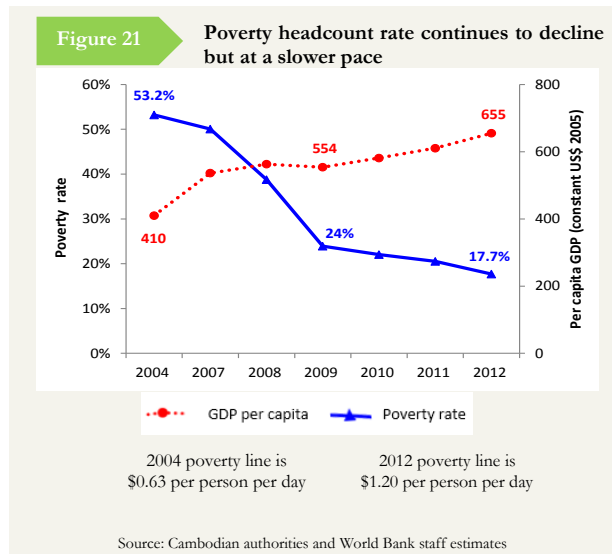
Poverty in Cambodia under the US\$ 1.25 PPP a day measure (which allows for international comparisons) was 6.0 percent in 2012, compared to 28.8 percent in Lao PDR, 15.4 percent in the Philippines, and 10.9 percent in Indonesia; all countries with a GDP per capita at least 1.5 times that of Cambodia. While the US\$1.25 PPP poverty declined at an impressive annual average of 5.8 percentage points between 2007 and 2009, it slowed down to 1.36 percentage points between 2010 and 2012. The slower pace of poverty reduction in the recent years stems largely from a decelerating agricultural sector, on which the poor are dependent.

6. Poverty reduction

31. Poverty has continued to fall, but at a slower pace than before. As of 2012, the poverty headcount rate (according to the national poverty line) was 17.7 percent, almost 3 percentage points lower than in 2011, a pace of reduction that is significant, although slower than during the 2007-09 period (Figure 21).¹⁵

¹⁵ The national poverty line for 2012 is riel 4,654.7 (nominal terms).

32. Overall, growth has been pro-poor in



the recent past. Consumption in the bottom 40 percent of the consumption distribution grew at an average annual rate of 7 percent during 2007-12, almost double the 3.6 percent rate for the total population. This was mainly the result of a dynamic agricultural sector. Inequality has declined significantly, with the Gini coefficient falling from 32 in 2008 to 28 in 2012. Nonetheless, the progress in equality has slowed in the past few years. Poverty in Cambodia under the US\$ 1.25 PPP a day measure (which allows for international comparisons) was 6.0 percent in 2012 (See Box 5 for more detail).

33. In the next few years, rural poverty is likely to decline at a slower rate than in the past. In rural areas, further poverty reduction will be made more challenging due to slow crop yield improvement and reduced international agricultural commodity prices.

34. As in recent years, it is likely that inequality will decrease at a slower pace in Cambodia in the near term. The projected sources of economic growth in the short to medium term, mainly the construction, garment and tourism sectors, are unlikely to favor the poor disproportionately.

35. In the case of Cambodia, the expected effects of the recent oil price decline on

poverty reduction appear to be moderate. The decline will directly benefit consumers, given that there are no price controls. The 20 percent fall in local domestic prices at most represents a 1.5 percent consumption gain for the average household in Cambodia. But the benefits are even less for poorer households, as fuel (and most oil related goods) represents a smaller share of their household budget.

Key messages and recommendations

36. The key challenge will be to stimulate the agriculture, garment, and tourism sectors to boost economic growth and reduce poverty further.

37. Revitalizing garment sector growth in particular, as well as growth in the manufacturing sector more generally, will be instrumental in maintaining high growth and macroeconomic stability. This can be achieved in the short- to medium-term timeframe. First, to further strengthen and diversify exports, it will be vital to maintain stability in the labor market to benefit from relocation of industry from China. Second, it will be necessary to improve the business environment through the simplification and automation of business registration and trade facilitation processes, and the development of an enhanced investment law (see World Bank Investment Climate Assessment 2014). Finally, from a medium-term perspective, addressing the high cost of electricity by speeding up the incorporation of additional power supply from hydro and coal-fired power plants, making efficiency improvements, and fostering transparency of solicitation in power distribution and supply provision will also be positive.

38. Given land area constraints, rice production growth—which had been driven largely by cultivated area expansion—will depend more on increases in rice yield and quality. Successes in revitalizing pro-poor agriculture growth will likely be obtained mostly in the medium-term timeframe due largely to continued dampened agricultural commodity prices while the supply response may also take time. First, reducing logistics costs (with the establishment of a Logistics Task Force for Inter-ministerial Coordination) and doing business costs (to help address the main reasons for Cambodian

rice losing the competitiveness it has at farm gate prices) can be done in a relatively in a short time with a strong commitment. Second, further improving access to finance for rice producers and millers to increase milling volumes and reduce milling costs, requires a short- to medium-term response time. Finally, increasing public investment in agricultural advisory services, seed development and irrigation infrastructure to enhance shock resilience, and the opening up of new markets will have high impact but will be relatively time consuming and resource intensive. For more detailed set of recommendations see the forth-coming World Bank study “Agriculture in Transition”.

39. To improve tourism sector growth, efforts can be made to increase the time and money spent by tourists in Cambodia. This could be done by improving road transportation (linking borders, Siem Reap, key coastal areas and Phnom Penh), together with greater investment and coordination of efforts between central and local governments, the private sector, and local communities. Such efforts would all help to promote the diversification of tourist destinations beyond the Angkor Archeological Park. Promotion of regional tourist destinations and travel arrangements would also help capture a larger share of the world tourism market, which is growing.

40. Safeguarding stability in the rapidly expanding financial sector will help to ensure sustainable economic growth. Enhanced banking supervision in the nascent but rapidly expanding financial sector will help to prevent bubbles developing in the construction and real estate sectors, while also strengthening the country's resilience to possible higher volatility in international financial markets. With strong inter-ministerial coordination and commitment, successes in this area can be obtained in the short term as the technical and managerial capacity of the monetary and economic authorities has been

improved after years of continued successful performance.¹⁶

41. Cambodia will greatly benefit from further improved investments and spending efficiency in health, education and social protection, translating into significant productivity and welfare gains in both the short and long run. Although the country has seen major improvements in terms of coverage, low education attainment and malnutrition are more prevalent among the poor population. Despite Cambodia's remarkable progress in poverty reduction, most households that have escaped poverty have done so only by a small margin and remain 'near-poor', leaving them highly vulnerable. Recent initiatives with the introduction and funding of health equity and retirement funds are steps in the right direction. However, a better understanding of the coping mechanisms available for vulnerable households and their effectiveness would help to mitigate the risk of them falling back into poverty.

42. Further broadening of the tax base and strengthening of tax administration will help to improve collection, which is required to finance much needed development spending. Meanwhile, the rapidly rising wage bill will need close monitoring. Increased public investment to strengthen the agriculture and tourism sectors, as well as to support overall structural reforms discussed earlier, requires enhanced efficiency in public spending and additional financial resources. It will therefore be important to continue improving domestic revenue collection by further broadening the tax base and strengthening tax administration. Improvements in revenue collection continue to be made almost continuously and, therefore, it is important to keep up the efforts to further improve administration and good governance. While the rising wage bill clearly helps to improve living conditions of poorly paid civil servants, wage rises

alone will not be sufficient to improve service delivery. It will therefore be important to closely link pay increases with improved human resource management and performance outcomes. Furthermore, wage increases will require close monitoring in order to ensure that they remain affordable.

¹⁶ The inter-agency coordination may include but not limited to the National Bank of Cambodia, the Ministry of Economy and Finance, and the Securities and Exchange Commission of Cambodia.

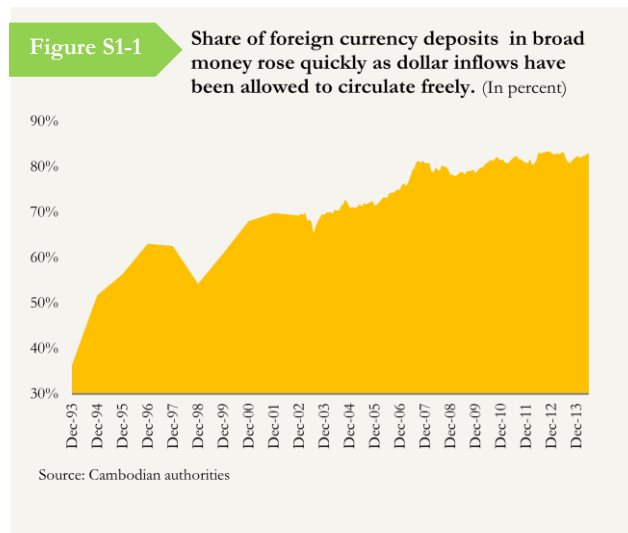
Selected Issue –Dollarization Issue: Advantages, Disadvantages and Ways Forward

1. Motivation

The objective of this selected issue on “Dollarization Issue: Advantages, Disadvantages, and Ways Forward” is to provide some views and lessons learned to support current efforts being made by the RGC to strengthen the use of the local currency, the Cambodian riel.

2. Brief background

In the late 1980s and early 1990s, Cambodia resorted to domestic bank financing to finance its fiscal deficits, which resulted in hyperinflation.¹⁷ This appeared to encourage the use of other currencies such as the US dollar (and to a lesser extent the Thai baht) to substitute the local currency.



US dollar substitution for the Cambodian riel began in 1992, when large inflows of US dollar provided to fund the first general election were allowed to perform all money functions alongside with the riel.¹⁸ Driven by continued free inflows of US dollars as the country opened up to foreign aid and investors, the share of foreign currencies (mostly US dollars) deposits in broad money rose rapidly from 36 percent (US\$30.7 million) at the end of 1993 to 63 percent (US\$145.8 million) at the end of 1996, effectively turning the primary currency—the riel—into the secondary currency over a period of just three years.¹⁹

The widespread use of US dollars by a country’s residents is a phenomenon called dollarization. Since 2007, the share of foreign currencies in broad money has reached around 80 percent and the economy has become dollarized (Figure S1-1). The share of US dollar deposits in total deposits has fluctuated between 92 percent and 98 percent during the past two decades. By December 2014, US dollar deposits reached almost US\$8.6 billion, more than half the size of the economy. The total value of US dollars in circulation, however, remains unknown. Various domestic and external factors determine the relative strengths of the costs and benefits of dollarization, as discussed below.

3. Advantages

The economy has achieved an impressive performance during the past two decades. This has led some to believe that dollarization in Cambodia has been a blessing, underpinning macroeconomic stability and growth, although such a hypothesis remains to be studied. A number of major advantages of dollarization are as follows:

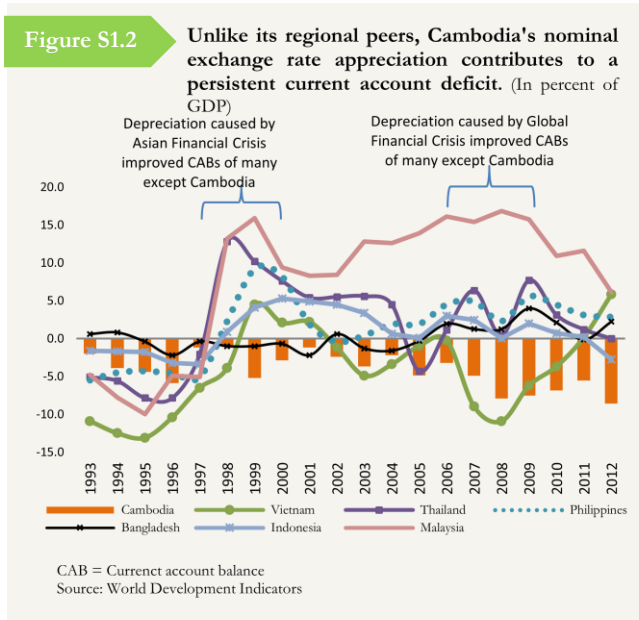
¹⁷ Printing money.

¹⁸ Tal Nay Im and Michel Dabadie 2007, Dollarization in Cambodia.

¹⁹ In the absence of effective monetary policy measures by the central bank to absorb US dollar inflows.

First, dollarization is known to constrain cash-strapped governments from resorting to domestic financing, a major cause of spiral inflation in the late 1980s and early 1990s in Cambodia. Dollarization, together with exchange rate targeting—pegging of the riel to the dollar—is considered to have anchored price levels. In a context of dollarization and a pegged riel to the US dollar, people think in terms of dollars, and prices in the domestic currency are indexed to the exchange rate; e.g., the price of local products tends to rise like the price of imported products when the riel depreciates (Im and Dabadie, 2007).²⁰ Therefore, a stable riel versus US dollar exchange change rate supports stable prices.

Second, during times of external shocks when there is a US dollar shortage, the total value of US dollars in circulation can help finance current account deficits, a role often played by foreign reserves. For instance, this contributed to Cambodia coming out relatively unscathed from the 1997 East-Asian Financial Crisis.²¹



Third, other proponents of dollarization believe it is most beneficial to a small open economy, like Cambodia, heavily trading with other dollarized partners, with a business cycle highly correlated with that of the US. They see Cambodia’s monetary policy focusing on supporting economic growth rather than counter-cyclical stabilization.²²

Fourth, by eliminating exchange rate risk, dollarization attracts capital inflows and facilitates high level of openness, fostering Cambodia’s liberal trade and investment regimes.²³

4. Disadvantages

The Cambodian authorities acknowledged in its Rectangular Strategy (RS) Phase 3 that the

economy remains highly dollarized which imposes limitations on monetary policy. The RS, therefore, opts for the continuation of a managed float exchange rate regime to maintain stability of the riel, while strengthening public and investor confidence in the local currency to promote its greater use and reduce the high level of dollarization.²⁴ The 2014-18 National Strategic Development Plan (NSDP) of the RGC also calls for a greater control over the economy, especially monetary policy, and concludes that de-dollarization should be the first step toward this.²⁵ Specifically, the NSDP advocates the utilization of riel-denominated

²⁰ Tal Nay Im and Michel Dabadie 2007, Dollarization in Cambodia. Prices of most goods (and services) in Cambodia are indexed by suppliers to riel versus US dollar exchange rate (and to riel versus Thai baht exchange rate as well). For instance, a dozen of locally produced oranges cost CR 10,000 when the riel versus dollar exchange rate is CR 4,000; this means the dozen of oranges cost US\$2.5. If riel depreciates to CR 4,100 per US dollar, the same will cost CR 10,250 (the cost likely reaches CR 10,300 as Cambodia does not circulate riel 50 bank note anymore); and this is equivalent to US\$2.51, a full exchange rate “pass-through” to prices.

²¹ During the crisis, Cambodia did not experience any major devaluation while Thai Baht lost 54 percent of its value against US dollar between June 1997 and January 1998. Cambodia’s real growth rate was 4 and 5 percent in 1997 and 1998, respectively (followed by double-digit growth for the subsequent two years in a row) while Thailand’s growth contracted by 2.8 percent and 7.6 percent in 1997 and 1998, respectively.

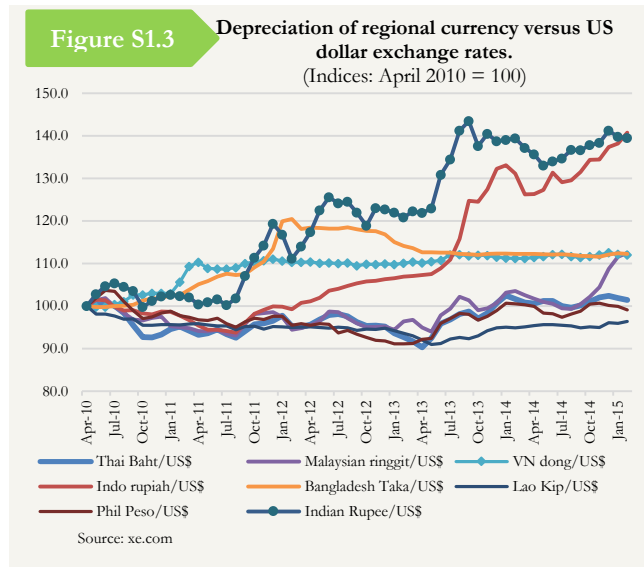
²² Box 7.1: Full Dollarization, De-Dollarization, or Status Quo? Cambodia Sustaining Rapid Growth in a Challenging Environment, Country Economic Memorandum 2009, the World Bank.

²³ Hellerstein and Ryan 2011, Federal Reserve Bank of New York Staff Report, Cash Dollar Abroad, February 2011, one percent higher openness ratio (defined as a country’s total imports and exports divided by GDP) is associated with 1.32 percent higher US dollar flows (page 22).

²⁴ See pages 7 and page 18, the Rectangular Strategy Phase 3 (Unofficial English version), RGC 2013.

²⁵ See para 6 on page 8, the 2014-2018 National Strategic Development Plan (NSDP) (Original Khmer version).

investments, such as treasury bills and government bonds.²⁶ The main disadvantages of dollarization are discussed below.



First, dollarization at least partly renders Cambodia’s exports and the production of tradable goods less competitive compared with its low-income peers due to nominal exchange rate appreciation vis-à-vis other currencies. With dollarization, an exchange-rate peg, and a liberal trade and investment regime, wide currency account deficits persist (Figure S1.2), resulting in increased vulnerability to external shocks.²⁷ In addition, many regional currencies have depreciated against the US dollar over the past five years (Figure S1.3) and the lack of monetary policy flexibility in the face of an appreciating exchange rate is becoming a concern.²⁸ As discussed the real sector above, in value terms, the share of Cambodia’s garment export to the EU rose to 40 percent of the total garment exports while that

to the US was only 34 percent in 2014. The recent US dollar versus Euro appreciation reduces Cambodia’s export competitiveness to the country’s largest export market, the EU.²⁹

Second, some rough estimates put the loss of seigniorage at between US\$1 and US\$2 billion.³⁰

Seigniorage is the gain (or loss) resulting from circulating the face value of a currency minus the cost of producing it. There are three types of seigniorage losses (Kang, 2005)³¹: (i) direct losses from renouncing the printing of a currency by allowing US dollars to circulate freely; (ii) annual seigniorage loss due to an inability to conduct “inflation neutral” currency injection;³² and (iii) forgone interest income by the central bank as a result of not being able to collect or lend the US dollar cash that is currently in circulation. To find out the amount of seigniorage loss, one would have to first quantify the unrecorded amount of US dollar cash in circulation which is hard to estimate precisely. Estimates vary as shown in Table S1-1, and they are significant.

Table S1-1 – Various estimates of US dollar cash in circulation in Cambodia in their respective years

(in bln of US\$)	Kang (2003)	Im and Dabadie (2006)	Feige (2006)	Article IV (2010)
US dollar cash in circulation	*1.01	3.5	2.00	-
(Derived) seigniorage loss	0.75	2.7	2.02 (2010)	1.23

Source:
 Is dollarization good for Cambodia? Global Economic Review, Kiwon Kang, 2005
 Dollarization in Cambodia, Tal Nay Im and Michel Dabadie, 2007
 New estimates of US currency abroad, Edgar L. Feige, 2011
 IMF Article IV staff report (2010), Box 2. Seigniorage loss could range from 5-19 percent of GDP (mid-point: 14% of GDP or US\$ 1.23 bln) estimated based on currency in circulation in comparator low-income countries in Asia.
 *Using Kang’s method to estimate US dollar in circulation in 2003

amount of US dollar cash in circulation which is hard to estimate precisely. Estimates vary as shown in Table S1-1, and they are significant.

²⁶ See para 3.45 on page 159, the 2014-2018 NSDP (Original Khmer version).

²⁷ In general, current account deficits driven by trade deficits which are caused by high demand for capital goods and raw material imports needed to develop production sectors such as agriculture and manufacturing sectors during the early stage of economic developments are appropriate. However, persistent current deficits driven by sustained high import demand that is fueled largely by domestic consumption including less productive investments in some sectors such as construction, land, and real estate in a speculative nature actually increase vulnerability to external shocks.

²⁸ Box 7.1: Full Dollarization, De-Dollarization, or Status Quo? Cambodia Sustaining Rapid Growth in a Challenging Environment, Country Economic Memorandum 2009, the World Bank

²⁹ For Cambodia, garment exports account for 75 percent of total exports.

³⁰ A survey reportedly discussed in a 2006 US treasury report revealed that Cambodia was holding US\$2 billion in cash or 0.7 percent of the total US\$281.7 billion bills classified as “foreign holdings of US currency”, while during the period 1994-2010, US Federal Reserve’s seigniorage earnings is US\$289 billion (Feige, 2011). Let’s conservatively assume that Cambodia continued to hold only 0.7 percent of the total US dollar cash abroad in 2010; this implies that seigniorage loss for Cambodia is about US\$2.023 billion (US\$289 x 0.7%) as of 2010.

³¹ K. Kang: Is dollarization good for Cambodia? Seowon University, Republic of Korea.

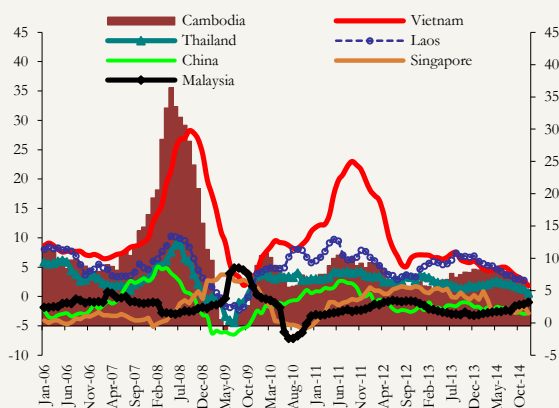
³² As economy grows, the volume of circulation currency also increases. The government can print money without inflation as long as the amount of money supplied is no more than the amount required by the economic growth.

Third, dollarization and exchange targeting may not anchor price levels as well as one might expect.

Cambodia's inflation is almost as volatile as that of Vietnam (Figure S1.4), and it is not much better than regional peers. In the wake of the 2008 global financial crisis, Cambodia's inflation skyrocketed due largely to "imported" inflation caused by world food and petroleum price shocks. This happened because dollarization facilitates (with freely circulated US dollars and riel) full "pass-through" of prices of imported goods denominated in US dollar to prices of domestically produced goods denominated in riel. This is because domestic producers hedged to maintain not only US dollar equivalent value of their goods but also the purchasing power received from selling their goods. In this regard, domestic producers effectively "index" prices of their domestically produced goods to prices of imported goods, and increase prices of their goods when imported goods become more expensive, although the riel versus US dollar exchange rate remains stable.

Figure S1.4

Cambodia inflation is almost as volatile as that of Vietnam and not much better than regional peers. (Y/Y % change)



Source: Cambodian authorities

Fourth, the key feature of dollarization is a fixed exchange rate (riel versus US dollar exchange rate peg) which constrains trade policy.³³ As a result, the Cambodian authorities are unable to protect the economy from external shocks through the control of exchange rates.³⁴

Experience in El Salvador shows that dollarization does not automatically lead to higher growth rates. This is because it does not make up for a poor business climate, high crime rates, or widespread violence.³⁵

5. Ways forward

In the early stages of development of the banking sector, with its newly established monetary authorities, human resources capacity and a regulatory framework to manage monetary policy in Cambodia were weak. Therefore, at that time, the benefits of dollarization outweighed the costs. Dollarization helped to avoid the hyperinflation and supported the earlier structure of international trade in which the US was the main export market for Cambodia's narrowly based export products, namely garments. As Cambodia's export products and destinations have become more diversified, dollarization has led to reduced competitiveness.

But the constraints imposed by dollarization are becoming particularly apparent for the management of Cambodia's rapidly expanding banking and financial sector. It is therefore important to restore the central bank's ability to serve as lender of last resort in the case of a sudden large shock. The ratio of gross international reserves to private sector deposits reached its record low of 53 percent in December 2014, down from 103 percent in December 2005, reducing the central bank's capacity to stabilize the banking system when facing a financial crisis. Other countries also seek to limit the extent of dollarization, owing to its potentially adverse effects on macroeconomic policy and financial stability (Kokenyne, Ley, and Veyrune, 2010).

³³ In dollarized economies, local authorities are likely to peg their local currencies to the US dollar because: (i) if they devalue their local currencies, their economies could become fully dollarized; (ii) if they overvalue their currencies, they could be running down their international reserves.

³⁴ Kang (2003) argues that currently, most goods are produced (and imported) and sold (and exported with their prices expressed in US dollars. Under the situation that more than 70 percent of all transactions use the US dollar, the exchange rate (riel versus US dollar) seems to lose most of its original meaning.

³⁵ De-dollarization workshop (2014), dollarization and de-dollarization experiences in LAC, Auguste Kouame, the World Bank,

“Once dollarization takes hold, economic agents are reluctant to switch back into using the local currency, because they lack confidence and the cost of redenominating transactions is high until a consensus is reached among market participants to use the local currency.” (Kokenyne, Ley, and Veyrune, 2010). In addition, Cambodia’s exceptional economic performance and investors’ confidence actually drive dollarization, instead of decreasing it, as the country attracts large capital inflows (Menon, 2008; and Duma, 2011). A weak correlation between deposit dollarization (and credit dollarization) with the nominal riel versus US dollar exchange rate also helps to confirm this.³⁶ This implies that dollarization in Cambodia is likely to stay unless addressed.

Developing a roadmap to increase the use of riel, as currently planned by the authorities, is a positive step. First, determining: (i) what monetary framework—inflation targeting or exchange targeting (pursuing a basket of currencies to anchor expectations while minimizing volatility for the tradable sector)—is the most appropriate; and (ii) how to promote confidence in such a framework. Second, further enhance the capacity to run proper monetary policy. Third, learning from the experience of a number of successful countries.³⁷ See Table S1-2 for a summary of key macroeconomic settings that promote de-dollarization.³⁸ Prudential measures, developing domestic currency capital markets together with foreign exchange markets, and exchange rate appreciation promote de-dollarization.³⁹ The implicit guarantee of a stable exchange rate may instead reinforce dollarization by encouraging borrowing in US dollars.

Country	Key macroeconomic settings	Prudential regulations under banking and financial sector	Deposit and credit de-dollarization
Peru	<ul style="list-style-type: none"> Improved fiscal balance Debt reduction to 19.6% from 48.2% of GDP Appreciation of exchange rate Sterilized foreign exchange market intervention Improved international reserve position Development of capital market in local currency Inflation targeting 	<ul style="list-style-type: none"> Large spread between reserve requirements in foreign and domestic currencies Remuneration rate on reserve requirements increased in domestic currency, exceeding that in foreign currency Provisioning requirements for foreign currency loans – building a reserve from 0.25% to 1% of credits in foreign currency Liquid assets in domestic currency is 8% while those in foreign currency is 20% Bank’s long open position reduced from 100 percent to 75 percent of capital 	<ul style="list-style-type: none"> Credit dollarization of 40% (2014) reduced from 82% (1992) Deposit dollarization of 32% (2014) reduced from 63% (1992)
Bolivia	<ul style="list-style-type: none"> Nominal appreciation (Bs/USD) 7.0 (2013) vs 7.5 (2002) Real appreciation (2005=100): 69.0 (2013) vs 83.0 (2002) Fiscal balance (% of GDP): 0.7% (2013) vs - 8.8% (2002) Public debt reduction (% of GDP): 37.3% (2013) vs 84.8% (2002) Improved foreign reserves (% of GDP): 47.6 (2013) vs 11.3 (2002) Development of capital market in local currency Inflation 6.5 (2013) vs 2.4 (2002) 	<ul style="list-style-type: none"> Higher exchange rate bid-ask spread, from 1 to 10 cents Tax of 0.3 percent on dollar financial transactions Higher mandatory reserves on dollar deposits from ~10% to 67% in 2006 Provisions for foreign currency loans up to 1.5% Bank’s long open position reduced to 60% from 70% 	<ul style="list-style-type: none"> Credit dollarization of 11% (2013) reduced from 74% (1996) Deposit dollarization of 23% (2013) reduced from 94% (1997)

Sources: World Bank, De-dollarization workshop (2014) and dollarization and de-dollarization experiences in LAC, Auguste Kouame.

³⁶ There are two types of dollarization: (i) deposit dollarization measured by US dollar deposit as a share of the total deposit; and (ii) credit dollarization measured by US dollar credit as a share of total credit. All other things being equal, depreciation of the riel increases the attractiveness of the US dollar and leads to increased dollarization and vice versa. Correlation between deposit dollarization and credit dollarization with the nominal exchange rate of only 0.47 and 0.24, respectively implies the nominal exchange rate changes (appreciate or depreciate) only weakly affect (decrease or increase) deposit and credit dollarization.

³⁷ A numbers of Latin American and Eastern European countries namely Peru, Paraguay, Uruguay, Bolivia, Armenia, and Georgia that have made good progress towards de-dollarization

³⁸ IMF working paper (2011), what is driving financial de-dollarization in Latin America? Mercedes Garcia-Escribano and Sebastian Sosa

³⁹ Hayk Avertisyan (2014), de-dollarization policy in Armenia: a room for policymaking, workshop on de-dollarization policies and challenges, Research Center of the Central Bank of the Republic of Armenia, December 12-13, 2014, Dilijan, Armenia.

Cambodia: Key Indicators

	2011	2012	2013	2014e	2015p	2016f	2017f
	Year	Year	Year	Year	Year	Year	Year
Output, Domestic Demand and Prices							
Real GDP (% change yoy)	7.1	7.3	7.4	7.0	6.9	6.9	6.8
Domestic demand (% change yoy)	11.3	14.9	12.1	12.4	11.0	10.7	11.1
Consumer price index (eop, % change yoy)	4.9	2.5	4.6	1.2	1.5	2.0	2.0
Public Sector							
Government revenues (% GDP)	13.2	15.3	15.1	16.1	16.0	16.3	16.8
Government expenditures (% GDP)	22.8	21.0	21.5	20.4	20.5	20.5	21.0
Government balance excluding grants (% GDP)	-9.6	-5.7	-6.4	-4.3	-4.5	-4.2	-4.2
Government balance including grants (% GDP)	-4.6	-3.3	-2.7	-2.5	-3.8	-4.9	-4.7
Foreign Trade, BOP and External Debt							
Trade balance (US\$ million)	-1,490.0	-2,455.7	-2,598.4	-3,010.7	-3,345.9	-3,606.9	-3,897.3
Exports of goods (US\$ million)	5,219.5	5,632.8	6,890.2	7,569.1	8,397.7	9,487.2	10,768.0
(% change yoy)	34.4	7.9	22.3	9.9	10.9	13.0	13.5
Key export (% change yoy) 1/	31.7	7.0	17.6	11.7	12.0	14.0	14.0
Imports of goods (US\$ million)	6,709.5	8,088.5	9,488.6	10,579.8	11,743.6	13,094.1	14,665.4
(% change yoy)	22.7	20.6	17.3	11.5	11.0	11.5	12.0
Current account balance (US\$ million)2/	-881.9	-1,366.0	-1,639.0	-1,853.2	-2,157.7	-2,259.9	-2,441.0
(% GDP)	-6.8	-9.6	-10.7	-11.2	-11.7	-11.6	-10.9
Foreign direct investment (US\$ million)	1,343.8	1,697.9	1,826.1	1,717.4	1,660.0	1,620.0	1,590.0
External debt (US\$ million)	3,913.4	4,559.3	5,124.1	5,630.6	6,019.1	6,380.5	6,692.7
(% GDP)	30.4	32.1	33.4	33.9	32.7	32.9	29.9
Debt service ratio (% exports of g&s)	1.1	1.1	1.1	1.3	1.3	1.6	1.4
Foreign exchange reserves, gross (US\$ million)	3,031.6	3,463.0	3,642.5	4,657.9	5,120.0	5,530.0	5,960.0
(months of prospective imports of g&s)	3.4	3.1	3.5	4.0	3.9	3.8	3.7
Financial Markets							
Domestic credit (% change yoy)	37.3	29.6	26.7	28.7	27.0	25.8	25.0
Short-term interest rate (% p.a.)	15.3	11.6	11.3	11.5	12.0	12.2	11.8
Exchange rate (Riel/US\$, eop)	4,039.0	3,995.0	3,995.0	4,075.0	4,050.0	4,050.0	4,080.0
Real effective exchange rate (2010=100)	104.9	105.4	109.9	112.1	113.5	115.5	117.8
(% change yoy)	4.9	0.5	4.3	2.0	1.3	1.7	2.0
Memo: Nominal GDP (US\$ million)	12,891	14,188	15,362	16,600	18,381	19,409	22,388

Sources: Cambodian authorities and World Bank staff estimates

e = estimate

f = forecast

p = projection

1/ Garments

2/ Excluding official transfers.



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