INTERNATIONAL MONETARY FUND

CAMBODIA

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

October 1, 2015

KEY ISSUES

Context. Economic activity remained strong driven by garments exports, real estate, and construction. Inflation decelerated strongly in late 2014 due to the sharp decline in oil prices and REER appreciation. While the outlook remains broadly positive, it is subject to substantial domestic risks as a result of rapid credit growth. External risks include weaker-than-expected growth in the EU and China and continued appreciation of the U.S. dollar.

Safeguarding macro and financial stability. Rapid credit growth, increasingly financed by bank flows from abroad, and with greater exposure to the real estate and construction sectors, poses significant macro financial risks. Raising reserve requirements and introducing well-designed macroprudential policies would help to moderate the pace of credit growth. Better monitoring of real estate developments is needed to contain risks. Further strengthening banking supervision and the regulatory framework, and completing a broader crisis management framework would support macro-financial stability.

Securing a strong fiscal buffer while meeting development needs. Deficits have been reduced on strong revenue performance. Continued fiscal consolidation is necessary to maintain adequate government deposits in view of spending pressures from a higher wage bill and an expected fall in official assistance. Steadfast implementation of the Revenue Mobilization Strategy is needed to safeguard fiscal space, and provide resources for development. Future public wage increases should be contingent on fiscal performance, and be accompanied by broad civil service reform.

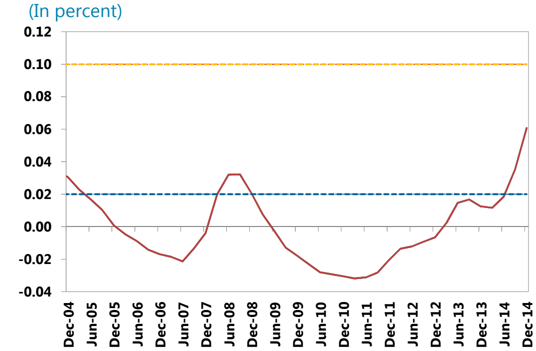
Promoting competitiveness, diversification, and inclusiveness. The changing patterns of China's trade and further regional integration through the ASEAN Economic Community provide opportunities for economic diversification. Greater investment in human capital and improving the business climate will help sustain robust growth and enhance competitiveness, foster economic diversification, and inclusiveness.

in line with weaker EU growth and further REER appreciation, robust real estate and construction activity, as well the reduction in oil prices, are projected to support growth.[1] Overall, growth is projected to remain steady at 7 percent in 2015 and rise modestly to 7.2 percent in 2016. Maintaining robust and sustainable growth over the medium term requires continued improvements in the business climate, infrastructure, and human capital.

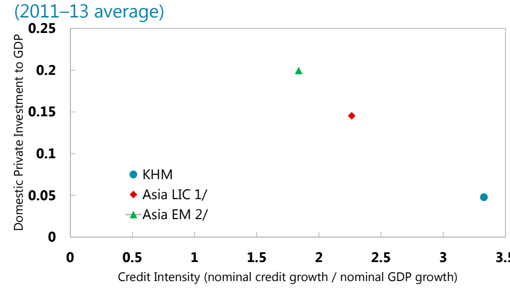
4. Inflation and output gap. While inflation decelerated strongly in the last few months of 2014 due to the sharp oil price decline and REER appreciation, average headline inflation in 2014 was 3.9 percent, about 1 percent higher than in 2013. The modest positive output gap (estimated at 0.7 percent) would have led to higher inflation in 2014 had external disinflationary pressures not been so strong.[2] Strong disinflation continued in the first half of 2015, with inflation falling to 1 percent in May. For the rest of the year, inflation is projected to rise gradually to around 2 percent by end-2015, reflecting the recovery in food prices and stabilization of global energy prices.

5. Credit developments. Rapid credit growth, which accelerated to 31 percent (y/y) by end-2014 (and remained on average around 33 percent in 2015 Q2), is posing an increasing risk. The credit-to-GDP ratio has doubled in three years to over 50 percent, exceeding the median emerging market (EM) and double the low-income country (LIC) levels. The speed of financial deepening has been striking, with credit growing much more rapidly than in peer Asian economies during their take-off. The loan-to-deposit (LTD) ratio breached 100 in February 2015.[3] This reflects both supply and demand factors:

Credit-to-GDP Gap, 2004-14
(In percent)

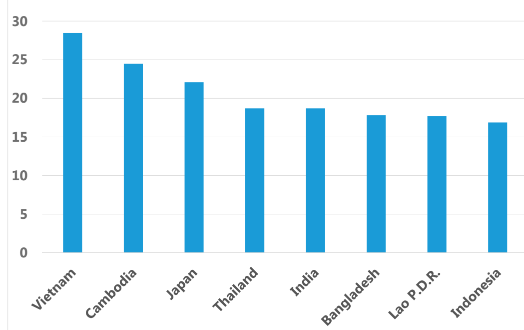


Credit Intensity and Domestic Private Investment
(2011–13 average)



Sources: Data from Cambodian authorities; and IMF staff calculation.
1/ Include Bangladesh, Myanmar, Mongolia, Sri Lanka, and Vietnam.
2/ Include India, Indonesia, Malaysia, Philippines, and Thailand.

Credit Growth in Similar GDP per Capita (PPP) Levels
(Five-year average)



[1] Staff estimates show that lower oil prices would boost growth (by 0.3–0.7 percent) in 2015, improve the current account balance, and lower inflation. Most of the oil market is controlled by private companies. There is evidence of limited pass-through of international prices to domestic prices; therefore most of the windfall will be saved as higher profits.

[2] Staff's calculation of a real-time coincident index based by pooling together high-frequency (monthly) economic indicators including imports, exports, and private sector credit, implies economic activity has been growing slightly above trend by about 0.5–1.0 percent.

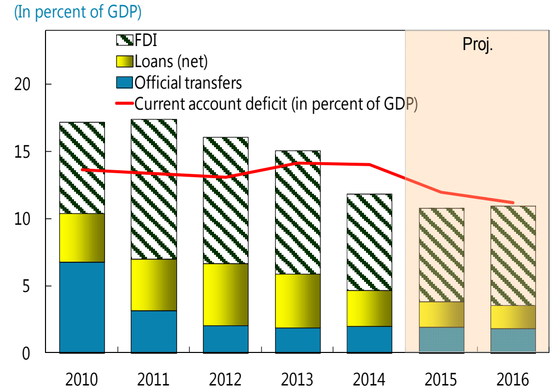
[3] The average LTD ratio masks the distribution of risks: a number of banks have LTDs much higher than 100 percent. LTD ratios are significantly higher in microfinance institutions that collect deposits but rely heavily on external financing, with an average of 193 percent in 2014.

accommodative monetary policy, new foreign bank entry, and buoyant domestic activity. Real estate-related lending grew by 53 percent (y/y) on average in 2015 Q2, while real estate prices rose on average 10–20 percent y/y in 2014. Credit growth is projected to be around 30-34 percent in 2015–16, and the credit-to-GDP gap is expected to exceed 10 percent by early 2017.[4] Cambodia's GDP growth has been one of the most credit-intensive, however, it has not been accompanied by an increase in private investment.

6. External stability. The current account deficit (CAD) is estimated at around 12 percent of GDP in 2014, and largely financed by FDI and official loans. Moderating garment exports and tourism growth were offset by lower power projects-related imports. The CAD is projected to narrow to around 11 percent in 2015, primarily due to the fall in oil prices. The CAD is forecast to decline to 6.3 percent of GDP by 2020, as major power projects are completed and exports grow with some product diversification amid AEC integration. Gross official reserves increased to US$4.7 billion by end-August 2015, nearly 4 months of prospective imports. Even though reserves appear adequate according to traditional metrics, in light of high dollarization and financial fragilities, analysis customized to dollarized economies suggests that there are benefits to building additional reserves (Box 1). As of August 2015, the REER appreciated by 8 percent compared to a year ago and is estimated to be broadly aligned with fundamentals. While exchange rate targeting has supported price stability by providing a credible nominal anchor, further strengthening of the U.S. dollar, as well as higher wage pressures, may weigh on Cambodia's competitiveness.

Current Account Deficit and Financing Flows, 2010–16

(In percent of GDP)



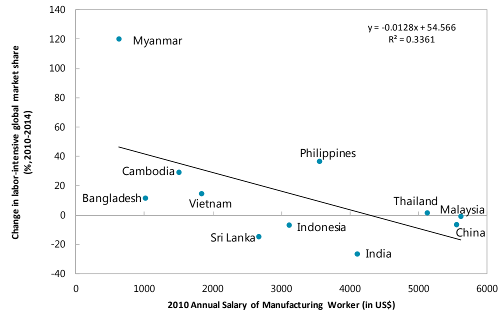
1/ Current account balance excluding official transfers.

[4] BIS analysis suggests that credit-to-GDP gap of 10 percent or more above trend indicates a high probability of serious banking strains in the following 2–3 years (Basel Committee on Banking Supervision 2010, Drehmann and others, 2010, etc.).

7. Risks, spillovers, and policy response. The outlook is broadly positive but subject to substantial downside risks.

- *Domestic risks.* The main risk reflects the rising financial sector vulnerabilities from rapid credit growth. Other domestic risks include fiscal pressures and erosion of competitiveness from wage increases potentially outstripping revenues and productivity improvements. The uncertainty related to wage policy and labor disputes could disrupt garment production and weigh on investor sentiment.

Wage and Changes in Global Market Share: labor-intensive



- *External risks* stem from a stronger U.S. dollar and/or a protracted growth slowdown in Europe constraining garments exports, amid stiff competition from other low-cost producers and wage pressures. Weaker-than-expected growth in China would also have spillovers through the FDI, banking and tourism channels (Risk Assessment Matrix and Box 2). If financial market stress re-emerges across the Euro area due to the Greece crisis, it would affect Cambodia through the FDI, trade, tourism, and banking channels via its impact on its Asian neighbors. Specifically, funding costs for Cambodian banks and microfinance institutions (MFIs), which rely increasingly on external funding, would increase leading to liquidity pressures and a credit crunch.

- *Policy response*. The room for policies to support growth in the face of large external shocks is limited, in view of high dollarization and a lack of monetary control, as well as insufficient fiscal space over the medium term. Efforts to build policy buffers and resilience should be stepped up preemptively. Should downside risks materialize in the near term and prove not to be short-lived (e.g., prolonged slowdown in the EU), efforts to diversify the economy should be expedited. Given the indexation of wages to the U.S. dollar and dollarized balance sheets, exchange rate flexibility may not provide a boost to the CA balance in the near term. In case of limited financial instability, liquidity buffers should be utilized. However, in the event of severe financial stress, a more comprehensive approach will be required, underscoring the importance of preemptively strengthening the crisis management framework.

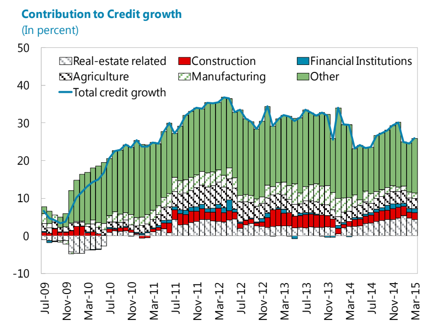
8. Authorities' views. There was broad agreement between staff and the authorities on the macroeconomic outlook and risks. The authorities have a similar assessment of the impact of recent oil price developments on the current account, and project a slowdown in exports for this year. They showed concerns regarding spillovers from Greece and EU growth on garment exports. They also noted risks related to the expected US interest rate hike. On the external sector assessment, while agreeing with staff on the medium-term assessment, authorities were more optimistic about the prospects for FDI this year.

POLICY DISCUSSIONS

Discussions focused on containing macro financial risks and preserving financial sector stability; continued fiscal consolidation to rebuild and secure fiscal buffers; and policies to promote competitiveness and inclusive growth.

A. Safeguarding Macro-Financial Stability and Fostering Market Development

9. Developments. Credit growth has been rapid, broad-based (across domestic and foreign banks as well as MFIs) and accompanied by a real estate boom. This has contributed to growing financial stability risks, rendering economic growth more vulnerable.[5, 6] Already-high dollarization has increased, with the ratio of foreign currency deposits to broad money rising from 79 percent in 2008 to 83 percent in 2014. The coverage of foreign currency deposits by foreign exchange reserves has steadily fallen, further limiting the NBC's lender-of-last resort capacity. Rapid credit growth is increasingly being financed by foreign funding amid ample global liquidity (with the share of foreign funding in total FX funding doubling from 10 percent in 2008–11 to 20 percent by 2012–14). Micro-finance institutions (MFIs) are now playing a systemic role, with credit stock and flows from MFIs at 20 and 25 percent, respectively, of those in the banking system. On average, deposit-taking MFIs exhibit LTD ratios of more than 200 percent, and are predominantly funded through foreign borrowing.



10. Past policy measures. Past monetary tightening (increase of reserve requirements (RR) by 50 basis points to 12½ percent in September 2012) did not dent credit growth momentum amid excess liquidity, strong deposit growth, reliance on foreign funding and the entry of new banks.[7] In August 2013, in line with past recommendations, the NBC issued NCDs, both in U.S. dollars and Khmer riel (KHR), to help develop the interbank market. After a slow start, in recent months, the primary NCD market has gained momentum and is expected to support banks' liquidity management and lay the groundwork for market-based monetary policy operations.[8] The expansion of reserve requirements to banks' foreign borrowing was instituted in March 2015, in line with previous Fund recommendations.

[5] Construction and real estate-related lending constitute around 19 percent of total credit stock and grew by 44 percent (y/y) on average by 2015 Q2.

[6] Residential real estate prices in prime locations have increased by over 30 percent and commercial prices by over 20 percent (y/y) in December 2014. Loan-to-value ratios are reported to trend upward of 70–80 percent.

[7] RR for KHR is 8 percent, while RR for dollars and foreign borrowings are 12.5 percent.

[8] After NBC's policy change in pricing structure, the role of NCDs as liquidity absorbing instruments for the NBC has improved. The volume of outstanding NCDs has increased from US$2 million in November 2013 to over US$100 million in February (10 percent of fixed deposits) in 2015. NCDs are also an important step in fostering the emergence of a formal secured interbank market. Additionally they provide a simple and transparent form of collateral for use in the overdraft facility.

Selected Financial Soundness Indicators (FSIs), 2011–14

(In percent)

	2011	2012	2013	2014
Capital Adequacy				
Regulatory capital to risk-weighted assets	26.23	25.00	24.84	21.49
Asset Quality				
Nonperforming loans to total gross loans	2.13	2.01	2.27	1.84
Earnings and Profitability				
Return on equity 1/	9.74	10.25	8.80	9.89
Return on assets 1/	1.76	1.72	1.78	1.82
Interest margin to gross income	64.27	66.65	69.03	69.70
Liquidity				
Liquid assets to total assets	16.16	15.37	17.89	17.38
Liquid assets to short-term liabilities	22.96	21.21	25.46	24.55

Source: National Bank of Cambodia.

1/ Annualized.

11. Supervision and regulation. Although core financial soundness indicators (FSIs) appear healthy, there is a trend decline in capital. Supervisory capacity remains heavily stretched given rapid growth of the financial system and large number of banks and MFIs. The NBC has been working on shifting to risk-based supervision consistent with FSAP recommendations and is also revising the current Liquidity Ratio in line with recent Fund technical assistance (TA) and previous Article IV recommendations.[9] To strengthen the crisis management framework, a Memorandum of Understanding (MoU) on establishing information sharing was signed with the MEF, the NBC and Securities Exchange Commission of Cambodia (SECC) in July 2014. The next step is to improve the quality of information, make progress on forming technical teams, and to provide robust resolution powers. While the NBC's current focus on liquidity risk and broader crisis management seems appropriate, with growing financial stability risks, the NBC should accelerate efforts to implement other FSAP recommendations (Table 8). These include strengthening supervision and upgrading regulation of the non-bank financial sector.

12. Growing financial stability risks. The priority is to address growing financial stability risks by stabilizing and moderating the pace of credit growth to more reasonable levels, while closely monitoring the effect on growth. LTDs in banks have risen indicating a heavier reliance on noncore funding, with 20 banks having LTD ratios over 100 and 12 banks with LTD ratios over 200 percent. The rise in noncore liabilities reflects the increased reliance on short-term external borrowing, raising liquidity risks. In the event of a spike in global financial market volatility, a reversal of foreign funding could lead to tightening of domestic liquidity conditions, leading to potential liquidity stress and a credit crunch, with adverse spillovers to real economic activity. Furthermore, some MFIs are now larger than some mid-sized commercial banks, and competing with banks while being subject to looser regulation. Real estate developers are also reportedly offering loans to buyers and are financed by foreign funding, while not being subject to stringent regulatory and supervisory oversight. Credit is increasingly being channeled to the real estate sector, which is exhibiting pockets of vulnerability.

[9] Under the current LR, banks can satisfy the minimum LR requirement of 50 percent but have a shortfall of maturing assets over maturing liabilities in the next 30 days. Although a large portion of banks' balance sheet are invested in liquid assets, they may face a short-term liquidity risks. The NBC is working on upgrading regulations on Liquid Asset Ratio (LAR) and Liquidity Risk Management (expected to be implemented by early next year). The LAR encourages banks to hold a prudent amount of liquid assets to cover expected net cash outflows over a 30-day period and to better monitor true liquidity conditions.