

CAMBODIA—ASSESSMENT LETTER FOR THE ASIAN DEVELOPMENT BANK

May 11, 2018

Recent Developments and Outlook

1. **Developments.** Cambodia's economy continues to grow at around 7 percent. Strong economic activity has been driven by construction and real estate sector activity, tourism and garments exports, aided by strong trading partner growth. Growth was also supported by higher public spending. Inflation unexpectedly picked up at end-2016 to 3.9 percent, driven mainly by higher food prices, but moderated to 2.3 percent in February 2018 as supply shocks dissipated. The current account deficit is estimated at around 8.4 percent of GDP in 2017 and is mostly financed by FDI and official loans. Foreign reserves have continued to grow, reaching around 5.2 months of imports in March 2018. The general government deficit is estimated to have widened to 2.6 percent of GDP in 2017, as continued revenue growth was more than offset by higher spending. Government deposits, a key fiscal anchor, increased to 12.6 percent of GDP and public external debt remained relatively low at about 30 percent of GDP at end-2017. Bank credit growth moderated somewhat to 19.7 percent in March 2018, but credit to real estate and construction related activities continues to grow at a much higher pace.

2. **Outlook.** Overall, growth is projected to remain steady at around 7 percent in 2018, supported by strong real estate and construction activity and exports. However, over the medium term, maintaining robust and sustainable growth requires stronger policy efforts in several areas (including ensuring continued macroeconomic and financial stability coupled with improvements in the business climate, infrastructure, and human capital). Inflation is projected to rise slightly in 2018 to just over 3 percent due to continued strong economic performance and rising commodity prices. The current account deficit is projected to widen to 9.1 percent in 2018, due to higher commodity prices and imports. The 2018 fiscal deficit is projected to increase further, to 4.4 percent of GDP, due to higher public wages and rising social and capital spending. The 2017 Article IV Debt Sustainability Assessment concludes that while Cambodia is at low risk of debt distress, the findings suggest increasing risks to the debt outlook, reinforcing the need for continued reforms to increase the economy's resilience to shocks, and further efforts to mobilize fiscal revenues.

3. **Risks.** The outlook is broadly positive but subject to significant downside risks. On the domestic-side political uncertainties could dampen consumer and investor sentiment. Rapid credit growth has resulted in the accumulation of financial stability risks, and fiscal pressures are building as revenue growth moderates and spending pressures rise. On the external front, a significant China slowdown would have large spillovers through the FDI, banking, and tourism channels, while a sharper than expected global financial tightening could raise funding costs and heighten liquidity risks. On the upside, stronger global growth may increase foreign demand for goods exports and tourism.

Economic Policies

4. **Macro-prudential measures to build financial sector resilience.** While credit growth has moderated somewhat, financial sector vulnerabilities remain elevated, driven by concerns over credit quality, growing exposure to the real estate and construction sectors, reliance on external funding and growing importance of micro-finance institutions. The recent introduction of higher minimum capital requirements and liquidity coverage ratio, improvements in loan classification, and counter-cyclical capital buffer regulations are welcome steps. Further efforts are required to bolster financial stability and resilience by upgrading supervisory capacity and strengthening regulatory frameworks, including tightening regulations for deposit-taking micro-finance institutions to align them with those of banks, and consideration should also be given to raising reserve requirements and introducing additional macroprudential measures. Banks' exposure to the buoyant real estate market also needs close monitoring and the authorities should expedite collection of data on the real-estate sector and household balance sheets to enable the introduction of targeted measures. Introducing a comprehensive crisis management framework with explicit inter-agency coordination mechanisms would support crisis preparedness.

5. **Revenue efforts to maintain fiscal sustainability.** Fiscal pressures are building as the wage bill and social spending are projected to rise significantly. Tax policy reforms are needed to sustain improvements in tax revenue over time and should initially focus on tax incentives and excises, and over the medium term aim at reforming VAT and personal income taxes, and increasing property taxes. The current five-year Revenue Mobilization Strategy (RMS) (2013–2018), which has helped produce large tax revenue gains, is due to expire, and efforts to produce a successor RMS for the period 2019–2023 are ongoing. Reforms are expected to focus on improving the efficiency and equity of existing tax policies, and strengthening transparency and accountability via improvements in tax administration. Introduction of a medium-term budget framework is needed to safeguard fiscal sustainability. The expenditure mix has become less growth-friendly (with the share of spending on wages increasing while capital expenditure has fallen) and, therefore, as revenue gains are secured, there is a need to raise social and capital spending, particularly on infrastructure, to boost competitiveness and increase inclusiveness. Further public-sector wage increases should be contingent on projected sustainable fiscal performance, and be accompanied by further progress in public administration reforms.

6. **Structural issues.** With a closely managed exchange rate, recent large increases in the minimum wage risk eroding competitiveness, particularly in the garment sector. Efforts are needed to diversify the economy and improve competitiveness to benefit from regional opportunities such as changing Chinese trade patterns and further ASEAN integration. Structural reform priorities should include greater investment in education and vocational training to improve skills, reforms to lower energy and logistics costs, and to improve the business climate. Further measures to encourage Riel use and reforms to develop capital and foreign exchange markets are needed to support financial development and inclusion.

7. **IMF Relations.** The 2017 Article IV consultation mission took place during July 12–25 and was concluded by the IMF's Executive Board on September 22, 2017. IMF technical assistance and training has focused on macroeconomic analysis and forecasting,

macroeconomic statistics and data dissemination, monetary operations, liquidity management and forecasting, interbank market development, banking regulation and supervision, AML/CFT, public financial management and tax policy and administration.

Table 1. Cambodia: Selected Economic Indicators, 2013–18

	2013	2014	2015	2016	2017	2018
					Est.	Proj.
Output and prices (annual percent change)						
GDP in constant prices	7.4	7.1	7.2	7.0	6.9	6.9
(Excluding agriculture)	9.5	9.2	9.2	8.5	8.3	8.2
Inflation (end- year)	4.7	1.0	2.8	3.9	2.2	3.3
(Annual average)	3.0	3.9	1.2	3.0	2.9	3.3
Saving and investment balance (in percent of GDP)						
Gross national saving	10.1	13.1	13.4	14.3	13.8	12.9
Government saving	2.2	3.4	3.8	2.8	1.5	0.2
Private saving	8.0	9.7	9.7	11.5	12.3	12.7
Gross fixed investment	23.5	23.2	22.4	22.9	22.2	22.0
Government investment	8.9	8.0	7.9	7.3	7.2	8.6
Private investment	14.6	15.2	14.5	15.6	15.0	13.4
Money and credit (annual percent change, unless otherwise indicated)						
Broad money	14.6	29.9	14.7	18.0	23.8	16.7
<i>Of which : riels in circulation</i>						
Private sector credit	17.3	31.3	27.1	22.5	18.5	15.0
Velocity of money 1/	2.0	1.8	1.6	1.6	1.3	1.2
Public finance (in percent of GDP)						
Revenue	18.7	20.1	19.6	20.7	20.4	19.6
Domestic revenue	13.7	16.6	16.5	17.3	19.5	18.9
<i>Of which : Tax revenue</i>	12.1	14.6	14.5	14.7	16.2	15.1
Grants	5.0	3.5	3.0	3.4	0.9	0.7
Expenditure	20.8	20.8	20.0	21.9	22.9	24.1
Expense	11.9	12.6	12.3	14.4	15.2	15.8
Net acquisition of nonfinancial assets	8.9	8.2	7.7	7.5	7.7	8.2
Net lending (+)/borrowing(-)	- 2.1	- 0.7	- 0.5	- 1.2	- 2.6	- 4.4
Net lending (+)/borrowing(-) excluding grants	- 7.1	- 4.2	- 3.5	- 4.7	- 3.5	- 5.1
Net acquisition of financial assets	0.2	2.3	2.2	1.9	2.3	0.6
Net incurrence of liabilities 2/	2.3	3.0	2.6	3.1	4.8	5.0
<i>Of which: Domestic financing</i>	- 0.6	- 2.2	- 2.3	- 0.8	- 0.2	- 0.3
Balance of payments (in millions of dollars, unless otherwise indicated)						
Exports, f.o.b.	6,974	8,156	9,550	10,513	11,492	12,554
(Annual percent change)	22.4	17.0	17.1	10.1	9.3	9.2
Imports, f.o.b.	- 10,467	- 11,640	- 13,187	- 14,088	- 15,349	- 16,998
(Annual percent change)	13.6	11.2	13.3	6.8	9.0	10.7
Current account (including official transfers)	- 2,042	- 1,690	- 1,625	- 1,731	- 1,871	- 2,209
(In percent of GDP)	- 13.4	- 10.1	- 9.0	- 8.6	- 8.4	- 9.1
Gross official reserves 3/	3,642	4,391	5,093	6,731	8,758	9,756
(In months of prospective imports)	3.3	3.5	3.8	4.6	5.3	5.5
External debt (in millions of dollars, unless otherwise indicated)						
Public external debt	4,852	5,269	5,610	5,861	6,671	7,620
(In percent of GDP)	31.6	31.8	30.8	29.0	30.1	31.5
Public debt service	143	172	239	244	192	313
(In percent of exports of goods and services)	1.4	1.4	1.8	1.7	1.2	1.8
Memorandum items:						
Nominal GDP (in billions of riels)	61,414	67,485	73,694	81,703	90,325	99,971
(In millions of U.S. dollars)	15,249	16,714	18,150	20,157	22,252	24,360
Exchange rate (riels per dollar; period average)	4,027	4,038	4,060	4,053	4,030	...

Sources: Cambodian authorities; and IMF staff estimates and projections.

1/ Ratio of nominal GDP to the average stock of broad money.

2/ Includes statistical discrepancy.

3/ Excludes unrestricted FCDs held at the NBC; starting in 2009, includes the new SDR allocations made by the IMF of SDR 68.4 million; starting, 2016 renminbi holdings are considered part of reserves following inclusion of renminbi in the SDR basket.