

**FOR
INFORMATION**

FO/DIS/21/61

April 21, 2021

To: Members of the Executive Board
From: The Secretary
Subject: **Cambodia—Assessment Letter for the Asian Development Bank**

Board Action: Executive Directors' **information**

Publication: Not yet decided*

Questions: Mr. Scott, APD (ext. 38169)

Cambodia—Assessment Letter for the Asian Development Bank

April 21, 2021

This note provides IMF staff's assessment of Cambodia's macroeconomic conditions, prospects, and policies. The assessment has been requested in relation to a proposed US\$40 million Financial Sector Development Program from the Asian Development Bank.

I. Recent Developments, Outlook, and Risks

1. The Covid-19 pandemic has taken a deep toll on Cambodia's economy. The economy was badly affected last year, primarily by the severe downturn of external demand, but also depressed domestic demand. Staff estimates a contraction of -3.5 percent in 2020, after recent years of 6-7 percent growth. Tourism and garment industries were hit hardest. Real estate and the construction sector also softened, with falling property prices and signs of oversupply of residential and commercial buildings, but this has not so far led to substantial financial stress. The external position was assessed in the most recent Article IV Staff Report to be substantially weaker than implied by fundamentals and desirable policies. Despite the downturn, FX reserves increased in 2020, to US\$21 billion (about 80 percent of 2020 nominal GDP), owing to substantial import compression, a surge in gold exports, and continued, although weaker, FDI inflows. The latest data show that FX reserves and government deposits remain broadly unchanged, at around US\$21 billion and US\$6 billion, respectively.

2. Staff expects a gradual recovery. Growth is expected to pick up to around 4 percent in 2021, supported mainly by stronger demand for manufactured goods. Growth rates are not expected to fully return to pre-crisis trend rates of 6½ to 7 percent until 2024.

3. Downside risks to the outlook remain heightened. Projections are unusually uncertain, with the outlook highly contingent on the pandemic. Downside risks continue to dominate. The most pressing is a significant and prolonged acceleration of the community outbreak of Covid-19 that began in late February. The outbreak itself and new restrictions on movement could significantly dampen domestic demand and, *in extremis*, supply. Widespread vaccination will not be achieved until the end of the year, even if all goes according to the government's plans. Another significant risk is that external demand recovers even more slowly in 2021 and into 2022 than projected and foreign investment decreases by more than anticipated. Domestically, the risk of a more rapid decline in the real estate sector could exacerbate liquidity pressures and asset quality in the financial sector. In these scenarios, substantial financing needs could open up; levels of FX reserves are notionally sufficient to meet external financing needs but could fall below what would be advisable for a highly dollarized economy. The main upside risk to the projections is from even stronger-than-expected bounce-backs in the South-East Asia, the US, and Europe.

II. Policy Responses and Settings

Fiscal Policy

4. A rapid policy response helped alleviate the effects of the pandemic. Strict virus containment measures were implemented, including to inward travel. The government rapidly adjusted fiscal policy: it increased the budget for health care¹, introduced wage subsidies and training for affected workers in the garments and tourism industries, granted tax relief, and boosted capital in state lending vehicles to facilitate guarantees and loans. A sizable social assistance package of cash transfers and work programs was targeted to poor households and affected workers.² To help fund the stimulus package and cover revenue shortfalls, other spending was rationalized, including a sharp reduction in purchases of goods and services (by 2.7 percent of GDP). As a result, the overall fiscal balance is estimated to have fallen from 3.0 percent of GDP in 2019 to -1.7 percent in 2020, and external public debt is estimated to have increased only modestly to 32 percent of GDP in 2020, from 29 percent in 2019. (Public domestic debt is negligible.) In 2019, Cambodia's risk of external and overall public debt distress was assessed as low.³

5. Fiscal policies should remain accommodative. The 2021 budget aims to restore government functions that were stripped back in 2020 and to continue supporting the economy. Staff projects the deficit to increase by about 1¾ ppt of GDP, with a corresponding increase in debt. Given the risks from the pandemic and of increased poverty and labor market scarring, staff supports the governments' plans for additional funds for outbreak prevention, active labor market measures, and retaining some form of social assistance to replace the emergency cash transfer scheme introduced in 2020. However, the planned incentives to boost output (e.g. tax expenditures, cheap loans to SMEs) require very close monitoring and active assessments of risks (also for government guarantees and PPP) to ensure that moral hazard is avoided and contingent liabilities are kept to a minimum. Ensuring value for money in expenditures, especially of capital spending, remains important,

6. Over the medium term, the authorities should continue efforts to improve revenue collection, increase spending efficiency, and reduce opportunities for corruption, so as to ensure fiscal buffers remain adequate and development goals can be met. The authorities will continue efforts on revenue mobilization, and can draw on the deposits at the central bank to finance the deficit. Increasing spending efficiency necessitates improving public investment management, as identified in the 2015 Public Investment Management Assessment and Public

¹ The government has finalized, in conjunction with the WHO, a vaccine plan that would have 10 million vaccinated by the end of 2021. So far, 8 percent of the population has received at least one dose. There is no explicit costing for vaccine purchases in the 2021 budget—the government plans to secure doses from the COVAX facility (7 million), China (1 million), Australia (3 million), and other potential supporters.

² USD300 million is targeted to a new monthly cash transfer program for poor and vulnerable households and USD100 million to work programs, together representing a 1.5 ppt of GDP increase in spending.

³ A formal update of debt sustainability will take place as part of the 2021 Article IV consultation, later in the year.

Investment Management System Reform Strategy 2019-25, and implementation of the Revenue Mobilization Strategy for 2019-23.

Monetary and Financial Policy

7. The National Bank of Cambodia (NBC) took steps to ease financial conditions, within the constraints of the policy framework.

- Monetary policy is constrained by the managed exchange rate and a high degree of dollarization. The NBC implemented several measures to improve liquidity, including decreasing banks' funding costs in domestic currency through cutting interest rates on banks' borrowing from NBC (liquidity providing collateralized operations, LPCOs); lowering required reserves that banking and financial institutions must maintain at the NBC, both in local (riel) and foreign currencies; and delaying additional increases in the capital requirements.
- The NBC also issued guidance to financial institutions on loan restructuring for borrowers experiencing financial difficulties in priority sectors (tourism, garments, construction, transportation and logistics); these terms have been extended through June 2021. Loan restructuring has been extensive; the authorities acknowledge the risk of moral hazard from extending such measures and are actively seeking exit strategies.

8. Going forward, the authorities will need to pay close attention to financial stability. The banking sector has sizeable capital buffers on average. However, extensive forbearance implies that capital in some banks is likely below what would be considered adequate. In addition, liquidity and concentration risks—especially in real estate—are high. Returning to pre-pandemic prudential practices, including appropriate asset classification and valuation, is essential, beginning with full reporting of loan reclassifications and of borrower creditworthiness, so that supervisors can decide on requirements for capital buffers and, where necessary, restructuring of financial institutions. In addition, a crisis management framework (including legislation for resolution procedures and deposit protection scheme) needs to be put in place.

Structural Policies and Issues

9. A strong and sustained recovery requires structural reforms to improve competitiveness and diversification and lower costs of doing business. The pandemic underscored the need to diversify and upgrade the economy from its reliance on tourism and low-skilled manufacturing exports, calling for reforms aimed at diversifying trade, upgrading skills, and improving governance⁴. The global trend of digitalization provides an opportunity for Cambodia to accelerate technology advancement and innovations to boost productivity.

⁴ Cambodia recently signed a bilateral trade agreement with China and RCEP among Asia-Pacific partners.

10. Improving governance remains a priority. Cambodia has scored relatively poorly on indicators such as regulatory quality and rule of law. Cambodia has taken steps towards improving its AML/CFT regime, but is behind on its action plan to address strategic deficiencies noted by the Financial Action Task Force.

IMF Relations

11. The most recent Article IV consultation was concluded by the IMF's Executive Board on December 6, 2019; the next is expected in the fall of 2021. The IMF continues to provide extensive technical assistance and training from headquarters, the Capacity Development Office in Thailand, and the Singapore Training Institute, on issues including public revenue management, central bank liquidity management, macroeconomic analysis, and data collection and official statistics. Cambodia has no outstanding financial arrangements with the IMF but would be eligible for several IMF facilities, including both short- and longer-term financial assistance.

Table 1. Cambodia: Selected Economic Indicators, 2016–22

Per capita GDP (2019, US\$) : 1,713
 Population (2019, million) : 15.6
 Poverty rate (2012, percent) : 17.7

Life expectancy (2019, years) : 75.5
 Literacy rate (2019, percent) : 87.7
 Gini (2012) : 29

	2016	2017	2018	2019	2020	2021	2022
					Est.	Proj.	
Output and prices (annual percent change)							
GDP in constant prices	6.9	7.0	7.5	7.0	-3.5	4.2	6.0
Inflation (end-year)	3.9	2.2	1.6	3.1	2.9	3.0	2.8
(Annual average)	3.0	2.9	2.4	2.0	2.9	3.1	2.8
Saving and investment balance (in percent of GDP)							
Gross national saving	14.2	15.1	11.5	8.1	9.5	5.0	7.0
Government saving	4.8	4.8	6.3	8.5	4.6	2.9	3.1
Private saving	9.4	10.2	5.2	-0.4	4.9	2.1	3.9
Gross fixed investment	22.7	23.0	23.7	23.9	22.0	23.0	21.6
Government investment	7.6	7.5	7.7	7.5	7.5	8.1	8.3
Private investment	15.1	15.5	16.0	16.4	14.5	14.9	13.3
Money and credit (annual percent change, unless otherwise indicated)							
Broad money	18.0	23.8	24.0	18.0	15.5	16.7	15.2
Private sector credit	22.5	18.5	23.2	26.3	16.0	17.5	14.0
Velocity of money 1/	1.5	1.4	1.2	1.1	0.9	0.8	0.8
Public finance (in percent of GDP)							
Revenue	20.8	21.6	23.9	27.1	22.5	23.1	22.7
Domestic revenue	18.3	19.7	21.7	25.1	21.3	21.3	21.2
Of which : Tax revenue	15.8	16.9	18.8	21.9	19.4	19.0	18.8
Grants	2.5	1.9	2.2	2.0	1.2	1.8	1.5
Expenditure	21.1	22.4	23.2	24.1	24.2	26.5	26.9
Expense	13.5	14.9	15.4	16.6	16.7	18.4	18.6
Net acquisition of nonfinancial assets	7.6	7.5	7.7	7.5	7.5	8.1	8.3
Net lending (+)/borrowing(-)	-0.3	-0.8	0.7	3.0	-1.7	-3.4	-4.2
Net lending (+)/borrowing(-) excluding grants	-2.8	-2.7	-1.5	1.0	-2.9	-5.2	-5.7
Net acquisition of financial assets	2.1	3.3	3.5	6.8	1.0	-0.9	-1.6
Net incurrence of liabilities 2/	2.4	4.0	2.8	3.8	2.7	2.5	2.6
Balance of payments (in millions of dollars, unless otherwise indicated)							
Exports, f.o.b.	10,278	11,229	12,963	14,987	17,293	16,717	18,420
(Annual percent change)	10.1	9.3	15.4	15.6	15.4	-3.3	10.2
Imports, f.o.b.	-14,121	-15,504	-18,806	-22,242	-20,758	-21,770	-23,755
(Annual percent change)	6.3	9.8	21.3	18.3	-6.7	4.9	9.1
Current account (including official transfers)	-1,699	-1,756	-2,993	-4,232	-3,245	-4,897	-4,257
(In percent of GDP)	-8.5	-7.9	-12.2	-15.8	-12.5	-18.0	-14.6
Gross official reserves 3/	9,122	12,200	14,628	18,763	21,194	21,335	22,676
(In months of prospective imports)	6.0	6.7	6.9	9.7	10.5	9.6	9.4
External debt (in millions of dollars, unless otherwise indicated)							
Public external debt	5,861	6,669	7,021	7,638	8,299	9,006	9,922
(In percent of GDP)	29.1	30.0	28.6	28.8	32.2	33.2	34.3
Public debt service	186	211	266	307	368	401	443
(In percent of exports of goods and services)	1.3	1.3	1.4	1.5	1.9	2.1	2.0
Memorandum items:							
Nominal GDP (in billions of Riels)	81,242	89,754	98,919	108,550	106,641	113,155	122,306
(In millions of U.S. dollars)	20,043	22,189	24,444	26,728	25,953	27,239	29,121
Exchange rate (Riels per dollar; period average)	4,053	4,045	4,047	4,061	4,109	4,154	4,200

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/ Includes unrestricted foreign currency deposits held at the National Bank of Cambodia; starting in 2009, includes the new Special Drawing Right (SDR) allocations made by the IMF of SDR 68.4 million; starting 2016, RMB holdings are considered part of reserves following inclusion of RMB in the SDR basket.