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IMF Executive Board Concludes 2008 Article IV Consultation with Cambodia

On January 16, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Cambodia.[1]

Background

Cambodia's economy has performed well in recent years, owing to a stable macroeconomic environment and double-digit growth. However, in 2008, conditions became less settled, owing to spillover effects from the global financial crisis and weakening external demand. Cambodia has been particularly vulnerable to recent shocks given its narrow production base, concentration of exports by product and destination, and dependence on external inflows. As a result, economic activity is slowing in most sectors and liquidity conditions are tightening. Rapid credit expansion since 2007 combined with weaknesses in bank supervision have heightened risks faced by a number of banks, including a few systemically important ones. On a positive note, inflation pressures, which were intensifying until mid-2008, has decreased owing mainly to the fall in commodity prices.

Real GDP growth is projected at 6½ percent in 2008 and 4¾ percent in 2008, compared to 10¼ percent in 2007. In 2008, garment exports and tourism activity moderated as external demand weakened. Agricultural growth was likely below-trend due to adverse weather. Construction activity—strong in the first half of the year—also faltered, as foreign direct investment slowed and credit growth decelerated. While agricultural output should pick up in 2009, garments and tourism are expected to act as significant drag on growth given weak external conditions. Real estate and construction activity will also likely slow further, as investment becomes more constrained by inflows and credit. Headline inflation is projected to moderate to 15½ percent (year-on-year) in December 2008 and 7½ percent (y/y) by end-

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

2009 on lower commodity prices and easing demand pressures. The current account deficit rose sharply in 2008 due to high oil prices and strong non-oil imports, but with these factors now reversing, the deficit in 2009 is projected to narrow. Nonetheless, the overall external position, which improved in 2008, could weaken in 2009 given decreasing private inflows. Gross official reserves, projected at US$2.0 billion (3.5 months of prospective imports), would fall to around US$1.9 billion (3.1 months of imports) by end-2009.

The fiscal stance continued to underpin stabilization efforts in 2008. The overall deficit is expected at around 1¾ percent of GDP, against an official target of 4¼ percent and an outturn of around 3 percent in 2007. Revenue performance was strong, in part due to improved tax and customs administration, and expenditure remained appropriately constrained. However, public financial management reforms lagged, in particular budget integration. Given the near-term outlook, the 2009 budget has a deficit target of 4¼ percent of GDP, leaving scope for countercyclical fiscal easing.

Monetary conditions, lax in the first half of 2008, have tightened as external inflows slow and policy measures take hold—mainly a doubling of the reserve requirement on foreign currency deposits to 16 percent in June. Credit growth, which exceeded 100 percent (y/y) in mid-2008, is expected to fall to around 60 percent by year-end, with growth likely to be significantly lower in 2009 as liquidity remains tight. However, liquidity management remains constrained by the lack of an operational framework at the National Bank of Cambodia (NBC), although gradual steps are being taken to address this weakness. Despite recent global developments, the riel was relatively stable against the U.S. dollar in 2008, as transaction demand for riel balances stayed strong with inflation high.

With the banking system under increased strain, tighter monitoring is required by the NBC of banks' compliance with prudential regulations to prevent systemic problems. The NBC continues to improve its supervisory capacity, but enforcement remains weak, in particular in dealing effectively with capital adequacy and loan provisioning. New minimum capital requirements have been approved for 2010. In addition, steps are being taken to strengthen loan classification standards and improve bank licensing procedures. Bank resolution plans are also being formulated to provide a solid framework for dealing effectively with troubled banks.

Over the near term, the balance of risk is to the downside, because of uncertainty about the length and depth of the global recession and its impact on external inflows. Adding to pressures is a recent loss in competitiveness stemming from high domestic inflation coupled with U.S. dollar strength vis-à-vis most major currencies, leading to a sharp real appreciation. Medium-term prospects for Cambodia will depend on maintaining macroeconomic and financial stability, improving governance and infrastructure, and taking other actions to strengthen competitiveness, including addressing skill deficiencies and streamlining business regulation.

Executive Board Assessment

Executive Directors commended the Cambodian authorities for maintaining sound macroeconomic policies, including strong budget performance, against the backdrop of an increasingly difficult external environment. Directors noted that the global economic downturn and financial crisis pose serious challenges to Cambodia, with potential adverse effects on economic activity, capital inflows, and the banking system. They welcomed the authorities' recognition of the need for a timely and decisive policy response. This will need to involve supportive fiscal and monetary policies, as well as improvements in financial sector oversight, public services delivery, and external competitiveness, aimed at reducing vulnerabilities and sustaining growth and poverty reduction.

Directors considered the modest easing of fiscal policy envisaged for 2009 as broadly appropriate, and recommended that the increase in government spending be focused on pro-poor social and infrastructure outlays. They encouraged the authorities to continue to strengthen revenue administration and, as conditions permit, broaden the tax base, building on recent improvements. Greater control over the government's wage bill could be exercised by linking future increases to comprehensive civil service reform. Directors also called for concerted efforts to strengthen public financial management by improving Treasury operations and budget coordination and integration, as well as a transparent fiscal regime for extractive industries.

Directors supported the current monetary policy stance, and saw room for a moderate easing as credit growth drops and aggregate demand pressures ease. They encouraged the authorities to make further efforts to increase policy effectiveness in the context of high dollarization, building on the Fund's technical assistance recommendations, and to work toward a more developed monetary framework. Directors saw the adoption of a clear strategy to manage liquidity risk as an immediate priority. In this context, they welcomed steps to develop a sound, transparent overdraft facility, but stressed the need for caution in designating eligible collateral. Efforts should also continue to improve the required reserve system.

Directors stressed the need for comprehensive measures to improve banking soundness, notably in the areas of supervision, enforcement of regulations, and bank licensing procedures. They commended the NBC for taking further steps to strengthen the prudential framework and capital requirements. Directors also stressed the importance of formulating banking resolution plans should the need arise, with a view to containing fiscal risk. They welcomed the authorities' intent to participate in the Financial Sector Assessment Program (FSAP) in early 2010.

Directors took note of the staff's assessment that the real effective exchange rate appears overvalued. They generally considered that the present exchange rate regime continues to provide an appropriate nominal anchor, given the high degree of dollarization and the stage of financial development. Directors agreed that greater exchange rate flexibility is the appropriate medium-term objective. In the meantime, external competitiveness should be safeguarded by maintaining a stable macroeconomic environment, along with steps to develop a more skilled workforce, improve public services and infrastructure, and streamline business regulations.

Directors encouraged the authorities to continue pursuing a prudent debt management strategy, given the moderate risk of external debt distress and uncertainty about near-term prospects. Consistent with this strategy, Cambodia should continue to borrow largely on concessional terms in the foreseeable future.

Directors encouraged the authorities to continue efforts to resolve outstanding arrears with official creditors, noting that a successful resolution could pave the way for consideration of a Poverty Reduction and Growth Facility (PRGF)-supported arrangement should the authorities request it. They welcomed the authorities' commitment to remain closely engaged with the Fund and Cambodia's development partners, in support of the country's reform agenda.

Public Information Notices (Pins) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2008 Article IV Consultation with Cambodia is also available.

Cambodia: Selected Economic Indicators, 2005–09
(Annual percent change, unless otherwise indicated)

	2005	2006	2007 Est.	2008 Proj.	2009 Proj.
Gross domestic product (GDP) at constant prices	13.3	10.8	10.2	6.5	4.8
Inflation (consumer price index, end-year)	6.7	2.8	10.8	15.5	7.4
(annual average)	5.8	4.7	5.9	20.0	8.2
Saving and investment (in percent of GDP)					
Gross national saving	14.6	19.9	17.4	9.1	11.9
Gross fixed investment	18.5	20.6	20.8	21.0	19.0
Of which: Government investment	4.9	5.7	6.1	5.6	6.3
Public finances (in percent of GDP)					
Revenue 2/	10.3	11.5	11.9	12.5	12.1
Expenditure	12.8	14.2	14.7	14.2	15.4
Overall budget balance (- deficit) 1/	-2.5	-2.7	-2.9	-1.7	-3.2
Foreign financing (net)	4.9	4.8	5.0	4.3	4.6
Domestic financing (net) 2/	-2.4	-2.0	-2.2	-2.6	-1.3
Broad money	16.1	38.2	62.9	4.9	2.6
Private sector credit	31.8	51.6	76.0	60.0	10.0
Balance of payments					
Exports (in millions of U.S. dollars)	2,910	3,694	4,089	4,363	4,197
Imports (in millions of U.S. dollars)	3,904	4,727	5,419	6,523	5,798
Current account balance (in percent of GDP, - deficit)	-3.8	-0.6	-3.4	-11.9	-7.1
Gross official reserves (in millions of U.S. dollars) 3/	915	1,097	1,616	2,033	1,933
(In months of months of prospective imports)	2.0	2.1	2.5	3.5	3.1
Public external debt (in millions of U.S. dollars) 4/ 5/	2,120	2,254	2,582	2,809	3,087
(In percent of GDP)	35.0	31.0	29.7	26.8	26.0
Memorandum items:					
Nominal GDP (in billions of riels)	25,754	29,849	35,039	42,999	48,691
(In millions of U.S. dollars)	6,286	7,264	8,690	...	...
Exchange rate (riels per dollar, end of period)	4,097	4,109	4,032	...	...

Sources: Data provided by the Cambodian authorities; and IMF staff estimates and projections.
1/ In 2006, includes transfer of the Multilateral Debt Relief Initiative (MDRI) proceeds as capital revenue.
2/ Includes funds in transit and payment orders in excess of cash released.
3/ Excludes unrestricted foreign currency deposits held as reserves at the National Bank of Cambodia and valuation changes.
4/ From 2006, includes the impact of debt forgiveness from the IMF under the MDRI.
5/ Debt owed to the Russian Federation is valued at 0.6 rubles per U.S. dollar with the standard 70 percent discount.