January 13, 2020
Approval: 1/21/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/101-2

10: 45 a.m., November 28, 2018

2. Cambodia—2018 Article IV Consultation

Documents: SM/18/264 and Correction 1; and Supplement 1; and Supplement 2

Staff: Turunen, APD; Sun, SPR

Length: 38 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
	I. Mannathoko (AE)
	E. Ondo Bile (AF), Temporary
	E. Rojas Ulo (AG), Temporary
	J. Shin (AP), Temporary
	A. Souza (BR), Temporary
Z. Jin (CC)	
	M. Mulas (CE), Temporary
L. Levonian (CO)	
	S. Benk (EC)
H. de Villeroché (FF)	
	K. Merk (GR)
S. Gokarn (IN)	
	M. Psalidopoulos (IT)
	Y. Saito (JA)
	M. Daïri (MD)
	P. Al-Riffai (MI), Temporary
	V. Rashkovan (NE)
	K. Virolainen (NO)
	L. Palei (RU)
	R. Alkhareif (SA)
J. Agung (ST)	
P. Inderbinen (SZ)	
	M. Cowie (UK), Temporary
	P. Pollard (US), Temporary

S. Bhatia, Acting Secretary
H. Malothra, Summing Up Officer
L. Briamonte, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
Asia and Pacific Department: O. Brekk, D. Corvino, N. Hansen, E. Kvintradze, A. Mourmouras, S. Rafiq, C. Rhee, J. Turunen. Legal Department: I. Luca, E. Mathias. Strategy, Policy, and Review Department: Y. Sun. Alternate Executive Director: A. Castets (FF). Senior Advisors to Executive Directors: Z. Abenoja (ST), N. Jost (NE), C. Sassanpour (MD). Advisors to Executive Directors: P. Braeuer (GR), D. Crane (US), P. Dhillon (IN),

P. Di Lorenzo (IT), G. Kim (AP), M. Mehmedi (EC), Y. Naruse (JA), K. Osei-Yeboah (MD), I. Skrivere (NO), M. Sylvester (CO), K. Lok (CC).

2. CAMBODIA—2018 ARTICLE IV CONSULTATION

The staff representative from the Asia Pacific Department submitted the following statement:

The information below has become available following the issuance of the staff report (SM/18/264). It does not alter the thrust of the staff appraisal.

The final 2019 budget law, which was only available in preliminary form during the mission, was recently approved by the National Assembly. The final 2019 budget foresees some additional spending, including on establishing an SME bank, with current expenditures around 0.3 percent of GDP higher than envisaged in staff projections based on the preliminary budget. As a result, the final budget projects a fiscal deficit of 3.7 percent in 2019 compared with a staff projection of 3.3 percent of GDP in the staff report. While the upward revision in spending does not alter staff's views on the macroeconomic outlook, it underscores the need to restrain current spending and raise revenues to address medium-term fiscal pressures, as recommended in the staff report.

Text Table 1. Cambodia 2019 Budget Law
(In percent of GDP)

	Staff Report 2019 BL	Revised Estimates 2019 BL
Revenues	20.6	20.5
Taxes	16.7	16.8
Grants	1.2	1.2
Other revenues	2.7	2.6
Total expenditure	24.0	24.2
Expense	15.5	15.8
Net acqusition of non-financial assets	8.5	8.4
Fiscal balance	**-3.3**	**-3.7**
GDP	109,220	109,220

Mr. Agung and Mr. Pham submitted the following statement:

The Cambodian authorities would like to thank the IMF mission team for the constructive and candid policy discussions, which centered on economic development since the 2017 Article IV consultation, the near-term outlook, and policies to achieve strong, inclusive and sustainable growth and resilience. The authorities are encouraged by staff's assessment that significant progress have been made in maintaining growth momentum, supported by sound economic fundamentals and impressive reforms.

Recent Economic Development and Outlook

Following more than two decades of strong economic growth, the Cambodian government has attained lower middle-income status. Driven mainly by garment exports, tourism and construction, the Cambodian government has sustained an average growth rate of around 7.7 percent during the period of 1995-2017, culminating as the eighth fastest-growing economy in the world. As global demand peaks in 2018, economic growth is expected to reach 7.25 percent, compared to 6.9 percent in 2017, supported by strong external demand and expansionary fiscal policies. Broad-based growth is expected to remain robust over the medium term, supported by stable inflation, manageable exchange rate and decent external position.

The authorities estimated that the current account deficit in 2018 will widen due to higher imports. However, the authorities expect the foreign reserves to continue to grow, reaching USD9.6 billion by the end of 2018, which is equivalent to around 5 months of prospective imports as estimated by the staff. In the medium term, the authorities expect that large foreign direct investment (FDI) inflows and increasing public investment in infrastructure will help expand the production capacity of the economy. Together with other ongoing structural reforms designed to boost the country's external competitiveness, this would help accelerate growth momentum in the longer run.

Notwithstanding the positive economic outlook, the authorities are mindful that the country is in a pivotal moment of transformation and major challenges remain to allow the country to fully unlock its potential growth and leap to the next stage of development. The authorities broadly agree with staff that the country is facing vulnerabilities stemming from the erosion of export competitiveness. This is attributable to current rising real wages, a buildup of vulnerabilities from a prolonged real estate and construction boom, and escalating trade protectionism and tensions. The authorities share staff's view that in time to come, the country should continue to be fully committed to managing macro-financial risks, safeguarding fiscal sustainability, supporting inclusive growth, and addressing governance vulnerabilities.

Fiscal Policies

While the authorities broadly agreed with staff's assessment and recommendations, they underscore the importance of the recent expansionary fiscal policy in supporting economic performance and in ensuring the success of their reform agenda. The overall fiscal deficit is projected to remain contained, thanks to significant efforts in enhancing revenue collection. The effects of the 2017 public wage bill increase on fiscal deficit was neutralized by considerable stronger revenue collection, with tax revenue growing by an impressive 26 percentage points. The authorities expect the 2018 revenue collection to remain strong, mostly stemming from the increase in direct taxes, including property taxes, which would help narrow the fiscal deficit.

After a period of expansionary budget policy between 2017-2018, the 2019 Budget Law is geared towards consolidation by restraining current spending. The authorities will maintain their prudent expenditure management with focus on improving human capital and infrastructure. The authorities estimate that while revenue may slow down in 2018, it is expected to pick up from 2019 onwards due to the adoption of the Revenue Mobilization Strategy II (RMS II). In this regard, the authorities highly appreciated the Fund's technical assistance in developing the Medium-Term Fiscal Framework (MTFF) and the RMS II, which aim to sustain revenue growth by reforming tax policies and revenue administration to improve their efficiency and equity. The authorities consider these plans as crucial to ensuring medium-term fiscal sustainability.

The authorities welcome staff's assessment that public debt is low at just over 30 percent of GDP and that Cambodia is expected to remain at low risk of debt distress. They agree with staff that fiscal risk from contingent liabilities should be monitored and well-managed, including those from increasing Public – Private Partnerships (PPP) projects, which call for limiting public guarantees and strengthening the institutional framework for PPPs.

Going forward, building on the significant progress achieved so far, the authorities are committed to strengthening fiscal governance through modernizing tax collection system and custom administration, and public financial management and procurement reforms focused on increasing spending efficiency, and improving fiscal transparency.

Monetary Policies

To support economic growth, the authorities pursued an expansionary monetary policy and were successful in maintaining low inflation. The authorities expect M2 growth to remain robust in 2018 and stay around 19 percent in the medium term. The expansionary policy stance has underpinned economic activity in the real sector in 2017 and the first part of 2018. Given a highly dollarized economy, the expansion is expected to be driven mainly by rising foreign currency deposits, boosted by improved confidence, together with developments in the equity, interbank, government and corporate bond, and foreign exchange markets.

In the meantime, efforts by the National Bank of Cambodia (NCB) in promoting the use of local currency have succeeded in increasing local currency in circulation in order to enable a more flexible and effective monetary policy framework and help increase resilience in the medium term. These measures have helped the NCB regain monetary policy independence, including short-term interest rate targeting and expansion of the use of local currency, currently curtailed by the high degree of dollarization. The NCB is also exploring the use of financial technology, such as mobile payments, in providing low-cost payment services.

Financial Sector

While the authorities welcome staff's assessment and recommendations on the current development and challenges in the Cambodian banking sector, they emphasize the broader importance of the banking sector's credit in supporting growth. The authorities are now considering financial and banking sector policies as an important tool for macroeconomic management. The Cambodian banking sector remains sound and profitable with adequate capital buffers as reflected by the core financial soundness indicators.

The authorities, however, are mindful of elevated financial sector vulnerabilities arising from high credit growth and the need to monitor the construction and real estate sector risks. To mitigate financial stability risks and bolster financial stability, the NBC has adopted key macroprudential policy measures, including the capital conservation buffer to be implemented in phases, a liquidity management framework, and improvements in banks' loan classification and provisioning rules. The authorities are also expediting data collection on the real estate sector as part of their efforts to better manage credit risk in this sector.

Further targeted prudential measures as suggested by staff are under consideration to maintain financial stability. These include raising risk weights for real-estate lending that helps reduce the scope for speculative activities, introduction of a crisis management framework with a deposit insurance scheme, and continued upgrading in regulation and supervision, including for non-bank financial institutions. The authorities are committed to make all efforts in complying with international standards, including addressing shortcomings in the Anti-Money Laundering/Counter Financing of Terrorism (AML/CFT) regime and building the Financial Intelligence Unit's (FIU) capacity.

Continuing the Reform Agenda

To maintain strong growth, the authorities underscore the importance of addressing structural constraints to potential growth. To do so, the authorities are fully committed to investing more in education and skills training while addressing the constraints facing small and medium enterprises (SMEs) to support economic diversification and promote job growth. The authorities consider investing in the Cambodian people to be the top priority and in the best interest of the Cambodian future.

Given a strong near-term economic performance, the authorities will push forward the necessary structural and governance reforms to achieve the government's target of 7 percent over the medium-term. The authorities agree with staff's recommendation of the need to improve the business climate, increase competitiveness and encourage diversification through lower energy costs, better human capital and infrastructure, strengthen the rule of law, enhance the capacity of the state to efficiently provide public goods and services, and to improve governance.

The authorities emphasize that addressing weaknesses in the governance structure, including corruption, remains a top strategic priority for the new government. The authorities are fully committed to continuing efforts in this area.

Conclusion

The Cambodian authorities will continue to implement the reform agenda to take full advantage of the country's growth prospects. The authorities are fully committed and determined to implement the necessary structural reform measures and policies that will improve the investment climate and sustain economic growth, while providing buffers against external and domestic shocks. Growth will be made more inclusive with continued focus on fiscal prudence, well-grounded monetary management and financial stability, improved competitiveness of SMEs, and confidence in the banking system. Our Cambodian authorities would like to express their appreciation to the Fund for their policy advice and invaluable technical support, and the authorities look forward to continued cooperation in the years to come.

Ms. Pollard and Ms. Crane submitted the following statement:

We thank staff for the helpful papers and Messrs. Agung and Pham for the informative buff statement. We welcome Cambodia's solid performance on growth, poverty reduction, and low inflation. We urge the authorities to take advantage of the strong economy to undertake reforms such as tax modernization, strengthening of macroprudential tools and improvements in the business environment that will help make the economy more resilient. We welcome the emphasis in the report on policies to improve governance and reduce the opportunities for corruption. We broadly concur with the staff assessment and highlight several points below for emphasis.

Fiscal and Debt Sustainability

While IMF staff currently assesses debt risks as low, vigilance is required to contain contingent liabilities, and to ensure that public investment, including PPPs, is channeled into high-quality projects that will boost growth. We welcome staff advice on a stronger fiscal anchor in the form of a public debt/GDP limit. Can staff comment on the authorities' interest in pursuing such a policy change? As Cambodia solidifies its lower middle-income status and highly concessional financing becomes harder to secure, it will be important to closely monitor the terms as well as the quantity of new debt, to keep debt service payments under control. We encourage the authorities to foster debt discipline through full transparency of public debt. We are concerned that despite the recent establishment of a central PPP unit in the Ministry of Finance, there is no publicly available estimate of PPP-related debt. We urge the authorities to step up efforts to gather and report on PPP data as soon as possible. We also support staff's recommendations to improve fiscal governance.

External Sector

Cambodia's current account deficit of ten percent is significantly above what would be considered prudent in most other economies even though it is driven by large inflows of FDI. We note that IMF staff assesses the exchange rate to be overvalued on the order of 5-8 percent. Can staff comment on whether substantial FDI is potentially feeding bubbles in the real estate and financial sectors? How resilient is the Cambodian economy to a slowdown in FDI flows?

Financial Sector

Cambodia has made important strides in developing its financial sector, but further efforts are needed to manage risks. We welcome the authorities' intention, referenced in the buff statement, to consider additional prudential measures aimed at risks emerging from the construction and real estate sectors. We also took note in the Risk Assessment Matrix that Cambodia faces a significant risk of a FATF listing which could threaten correspondent banking relationships and hold back investment; we urge the authorities to expeditiously implement recommendations from the regional FATF body. We welcome plans for ongoing TA on AML/CFT, noted in the Capacity Development annex.

Capacity Development

Cambodia is a heavy CD user, averaging over 30 TA missions per year. We commend staff for the very helpful annex on capacity development, including a multi-year strategic surveillance and CD matrix. Can staff comment on how resident advisors are being used in the Cambodia CD program?

Mr. Saito and Mr. Naruse submitted the following statement:

We thank staff for the informative reports and Mr. Agung and Mr. Pham for their insightful buff statement. It is encouraging that the economic activity is projected to remain robust, supported by stronger manufacturing exports, construction and tourism activity. However, elevated financial sector vulnerabilities and external risks, such as a global financial tightening, might hamper sustainable growth and development. Therefore, we encourage the authorities to safeguard fiscal sustainability, enhance financial sector stability, and implement structural reforms to support sustainable development. As we broadly concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

We encourage the authorities to secure room for growth-enhancing infrastructure and development spending. As staff say, we believe that this will help support growth and sustainable development. We welcome the fact that the authorities' preliminary 2019 budget is geared towards current spending restraint. We also welcome the reallocation of spending towards health and education sectors. While public wages are expected to grow in line with nominal GDP in the budget, we see merit in the staff's recommendation that further wage increases should be contingent on maintaining adequate fiscal buffers and supported by on-going public administration reforms. In addition, we commend the authorities for strengthening collection efforts to enhance revenue performance. We support the authorities' formulation of a new Revenue Mobilization Strategy, and we expect that this strategy would modernize the revenue administration and policies to improve the efficiency and equity of the tax system. Moreover, it is encouraging that the authorities are making progress towards introducing a medium-term fiscal framework (MTFF). And we expect that the MTFF would help safeguard infrastructure and development spending over the medium-term. Furthermore, we support the authorities' ongoing work to enhance fiscal governance, including strengthening e-filing and increasing tax auditing capacity. Lastly, we note a gradual decline in working-age population growth. Could staff comment on the fiscal implication of a decreasing working-age population?

Financial Sector Policy

We support the authorities' policy measures to address financial sector vulnerabilities. We welcome the authorities' steps to safeguard financial stability, such as the introduction of a liquidity risk management framework as well as the improvements in banks' loan classification and revisions to provisioning rules. It is also encouraging that banks' capital adequacy has increased. However, it is worrisome that vulnerabilities remain. We note with concern that the credit-to-GDP ratio continues to rise, and that credit is concentrated in the real-estate sector. We agree with the staff's view that the authorities need to strengthen the monitoring of the real-estate sector, including through collecting the real estate data. Also, while bank credit is expected to grow by around 20 percent in 2018, we note that micro-finance institution credit expands at an even higher rate (about 30 percent). We wonder if the difference on credit growth between banks and micro-finance institutions might come from different regulatory structure. How do staff assess the adequacy of the authorities' supervision and regulation on micro-finance institutions compared with banks? Moreover, we support the staff's call on enhancing regulation and supervision. We encourage the authorities to finalize and implement regulations on related-party lending and large exposures to align them with international best practice. Also, we expect that the authorities will continue to address shortcomings in the AML/CFT regime as well as introduce a deposit insurance scheme and a bank resolution framework.

Exchange Rate Policy

We note that Cambodia's dollarization level remains high. We note the staff's appraisal that promoting further financial market development and encouraging local currency use would increase resilience. At the same time, we believe that dollarization has contributed to stabilize prices and promoted the FDI. We would welcome the staff's comments on the merits and demerits of de-dollarization as well as the appropriate pace of de-dollarization.

Structural Reform

We encourage the authorities to accelerate the implementation of structural reforms aimed at supporting inclusive growth. It is encouraging that income inequality in Cambodia has declined and is lower compared to its peers. We also welcome stronger income growth than peers. However, we note with concern that total factor productivity growth has fallen. In this regard, we agree with the staff's view that the authorities need to increase competitiveness and encourage diversification, including through addressing skills gaps via improving the quality of education as well as promoting technical and vocational training. Could staff elaborate the recent developments of private wages and their effects on competitiveness in terms of attracting the FDI in a manufacturing sector? We are also concerned about inequality in household consumption between rural and urban areas. To support inclusive growth, we concur with the staff's recommendations that the authorities should expand economic opportunities and sustainable development, including through promoting higher productivity in the agricultural sector. Finally, as staff say, we believe that reducing the cost of setting up and operating businesses would support job creation and small and medium-sized enterprise growth. In this light, we support the authorities' ongoing initiatives to simplify the tax system and develop a competition law, which would help foster a level playing field for firms.

Mr. Rashkovan and Mr. Jost submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Agung and Mr. Pham for their informative buff statement. We welcome staff's horizontal assessment of the challenges to sustainability, both in terms of fiscal developments and emerging issues. While we commend the authorities for their successful efforts to increase income levels and labor productivity, while markedly reducing poverty, we encourage them to continue addressing inequalities, including on the rural-urban level as well as governance related challenges. We concur with staff on the key policy recommendations. The following points are for emphasis.

We welcome staff's transparent application of the new LIC-DSA framework and support their clear and comprehensive set of recommendations regarding fiscal matters, including the necessity to maintain fiscal buffers. In particular, we support staff's call for the introduction of a medium term fiscal framework and a fiscal anchor. Given the large projected public deficits, we agree with staff that ineffective current spending should be restrained, and that spending should be reprioritized towards priority infrastructure investment and human capital, including health and education. We welcome the progress made with revenue administration and public financial management including the efforts to put in place a debt strategy, which will likely contribute to better manage contingent liabilities. These efforts should be maintained. Indeed, while the DSA finds that Cambodia remains at low risk of debt distress, we take note of the fact that public and publicly guaranteed debt to GDP-ratio is set to increase by more than 10 p.p. during the next decade, despite strong economic growth rates of around 8 percent of GDP – adding to the country's vulnerability to external shocks. We also join staff in their call to reduce data gaps and further increase fiscal transparency.

We explicitly welcome the work done on climate change in the 2017 report on Cambodia. Staff found that: "Including climate change impact in the design of macroeconomic and structural policies, especially in the agriculture sector, would improve resilience." We commend staff for, even if briefly, following up on this climate change related recommendation and are pleased that the authorities implemented staff's advice. More generally, we also appreciate that staff included climate change, together with other emerging issues, in the assessment of forward looking priorities (Table 1, Annex III). We take note that staff considers the impact of climate change on macro-developments to be "medium", and the traction to be "low". In a similar vein, regarding the RAM we would like to ask staff why they classified extreme weather events as "internal risk"? From our perspective, increased risks from climate related developments are often outside of the authorities' sphere of influence and could be considered as external. That is, the authorities can manage the related risks – which will have fiscal implications but reducing the exposure to climate related developments seems difficult.

We welcome the authorities' commitment to further address governance and transparency challenges. Improving contract enforcement and the economic climate, by reducing informality, is likely to attract business and further investment. In this context, simplifying the tax system, reforming procurement processes, strengthening property right and developing a competition law are sensible next steps. We encourage the authorities to stay the course.

Mr. Benk and Mr. Mehmedi submitted the following statement:

We thank staff for the well-written and comprehensive reports, and Messrs. Agung and Pham for their helpful buff statement. We commend the authorities for achieving impressive economic growth and reforms over the last decade which have resulted in the reduction of poverty and a gradual diversification of the economy. While macroeconomic conditions remain favorable, Cambodia faces vulnerabilities, such as a less benign external environment and significant domestic headwinds, including contingent liabilities, high financial dollarization, weak governance, and low productivity. Against this backdrop, the authorities should intensify their efforts in safeguarding fiscal sustainability and addressing structural impediments to boost productivity, further reduce poverty, and address regional disparities. We broadly concur with staff's assessment and policy advice, and limit our comments to the following points for emphasis.

The adoption of a medium-term fiscal framework, including a fiscal rule, should complement the modernization of tax policy to provide a policy anchor and ensure the sustainability of public finances. Following expansionary fiscal policies this year, we welcome the authorities' plans to restrain current spending in 2019. In this context, we underscore the importance of further improving the composition of the budget through re-orientating expenditures towards investment in infrastructure, as well as the health and education sectors, while containing the increasing public sector wage bill. Considering the low tax-to-GDP ratio and the ample room to improve tax performance, we appreciate staff's policy recommendations on mobilizing domestic revenue and shifting the tax burden to more progressive direct revenue sources, including through raising real estate tax and phasing out exemptions. In this vein, the authorities' concerted efforts in implementing the new Revenue Mobilization Strategy to improve the efficiency and equity of the tax system are essential. These should also be complemented by policy reforms aimed at enhancing tax and customs administration and strengthening the public-private partnership (PPP) framework to better manage fiscal costs and risks. Staff's comments on the growing contingent liabilities and fiscal risks pertaining to the PPP program are welcome. We broadly agree that introducing a fiscal anchor based on a medium-term debt ceiling would strengthen policy credibility and help guide near-term fiscal policy decisions.

The buildup of macro-financial vulnerabilities should be addressed. We note that bank credit is expected to grow by around 20 percent in 2018, with micro-finance institution credit expanding at an even higher rate. Concurrently, risks to the banking system have grown from increasing household and corporate leverage. With capital continuing to flow in the construction sector, real estate sector risks should be promptly addressed by implementing targeted measures, including raising risk weights for real estate-related lending commensurate with banks' risk profiles, and implementing additional macro-prudential policies while ensuring prudent mortgage lending standards. At the same time, there is a need to enhance risk-based supervision and introduce a comprehensive crisis management framework. We are concerned about the weaknesses in the AML/CFT regime and call on the authorities to ameliorate the AML/CFT framework and avoid a public Financial Action Task Force listing. Staff's comments on the implementation status of the Fund's technical assistance recommendations on financial integrity issues, including AML/CFT, are welcome.

The steadfast implementation of structural reforms is essential to boost productivity, reduce inequality, and diversify the economy. In view of Cambodia's reliance on low-value added garments and its narrow economic base, reforms should aim at developing the business-enabling environment and the rule of law, addressing weaknesses in the labor market, advancing health and education outcomes, and improving social protection. At the same time, enhancing governance and fighting corruption are critical to ensure a level playing field and boosting investment.

Mr. Psalidopoulos and Mr. Di Lorenzo submitted the following statement:

We thank staff for their comprehensive report and Mr. Agung and Mr. Pham for their informative buff statement. We share staff's appraisal and, noting that also staff and authorities appear in broad agreement about the policy priorities, we limit our comments to the following.

Sustaining progress towards the SDGs while maintaining the debt in a low risk of distress requires comprehensively revamping tax and expenditures policies. We welcome the authorities' intention to reverse the procyclical fiscal stimulus provided in 2018. However, the fiscal position is projected to gradually deteriorate from 2020 on, as buoyant revenue performance registered in the recent past gradually stalls. This strengthens the case for the implementation of a new Revenue Mobilization Strategy focused on the efficiency of tax policies and the accountability of tax administration. Closing loopholes in direct taxes and reforming the property tax while implementing staff recommendations on tax and customs administrations are actions susceptible to grant reliable sources of revenues for priority areas such as social and capital spending. We support staff's recommendations to strengthening the PPPs framework to reduce fiscal risks and the crowding out of resources for other investments projects.

External borrowing should remain preferably on concessional terms. Moreover, as external debt is heavily concentrated in a single bilateral creditor, it is important to ensure the transparency of debt data, and we invite staff to remain vigilant on this front. How do staff assess the overall transparency of debt data, including access to concessional borrowing agreements? To preserve fiscal sustainability, consideration should be given to the introduction of a fiscal anchor in term of debt ceiling along the lines of staff's proposal.

Safeguarding financial sector's resilience calls for a prompt macroprudential action. Risks for the financial sectors come from the banks' large exposure to the construction and real estate sectors, partly fueled by FDI to the banking sectors amounting to 4 percent of GDP. We welcome that the authorities have adopted several policy measures broadly in line with past Fund advice and we strongly encourage them to monitor the credit cycle and to intervene pro-actively with targeted measures should signs of risk emerge. Moreover, supervisory capacity is also a source of concern. Looking forward, we attach particular importance to the introduction of higher risk weights on real estate lending and of an aggregate loan-to-value limit. A counter-cyclical capital requirement, as suggested one year ago, could represent an appropriate macro prudential tool to address the credit cycle. We encourage the authorities to continue promoting the use of the national currency, including by developing government bond markets. A higher buffer in terms of international reserves can be opportune given the current high share of FX deposit. Are, in staff opinion, the suggested macroprudential measures sufficient to provide enough safeguard to financial stability in case of a transition to a floating exchange rate regime?

Even though progress has been significant, there is still a large room for making growth more inclusive. Sustained efforts to reverse the trending decline in productivity growth are needed to reduce inequality and improve living standards. We concur with staff that further advancing sustainable development hinges upon strengthening the rule of law and reducing corruption and we welcome authorities' commitment to continuing efforts in this area. The shortcomings in the AML/CFT framework should be addressed to avoid a FATF listing that could negatively affect the business environment.

Mr. Virolainen and Ms. Skrivere submitted the following statement:

We thank staff for the report and Mr. Agung and Mr. Pham for their informative buff statement. We broadly share staff's assessment and offer the following comments for emphasis on the need to continue fiscal consolidation, address vulnerabilities in the financial sector, and advance the structural reform agenda.

The Cambodian authorities should use the current strong broad-based growth period to improve the sustainability of the fiscal position. We note that the final 2019 budget law envisages a slight deterioration of the budget deficit relative to staff's projections in the report. We encourage the authorities to restrain from further expenditure increases, in particular we share staff's comments on the need to accompany any further public wage increases with adequate fiscal buffers and public administration reforms. We welcome the progress on a new Revenue Mobilization Strategy. We agree with staff that reforming property taxes can help reduce inequality and provide a boost to economic growth.

Vulnerabilities in the financial sector need to be carefully monitored and addressed. Continued high credit growth, especially the high growth in micro-finance institution credit, the credit concentration in the real-estate sector, and the unmonitored and unregulated lending activity by real-estate developers is a cause for concern. We note that significant data gaps complicate the assessment of risks in the real-estate sector, and, therefore, urge the authorities to address these deficiencies. We share staff's policy recommendations on the need to strengthen the authorities' macro-prudential toolkit. Additionally, the authorities should advance their efforts to strengthen the supervisory framework and improve the enforcement of AML/CFT measures to avoid FATF listing. We wonder why the FATF listing is included as an external risk in the Risk Assessment Matrix, as it seems to be an area where the authorities could have a direct impact by strengthening their

AML/CFT framework. We would also appreciate if staff could elaborate on the most critical measures that are needed to avoid FATF listing.

While absolute poverty is close to being eradicated in Cambodia, more remains to be done to improve the living conditions of the population. The Cambodian economy relies heavily on low-value added garment production. Measures to improve the business environment, strengthen the rule of law, address governance and corruption vulnerabilities, enhance infrastructure, and improve the quality of education system outcomes should contribute to a more resilient and diversified economy.

We note that Cambodia is one of the most intensive users of Fund's Capacity Development in the region, having received about 165 TA missions over the past five years. We wonder if this is not stretching the absorption capacity of the country authorities and would appreciate staff's comments.

We encourage the authorities to consent to the publication of the Article IV report.

Mr. Inderbinen and Mr. Djokovic submitted the following statement:

We welcome the continued strong economic performance of Cambodia. Growth rates are impressive, also in regional comparison; the progress towards reaching the SDGs and reducing poverty has been remarkable; and the government debt-to-GDP ratio remains low. We welcome the positive economic outlook. This said, a strengthening of buffers is called for, also given the risks stemming from the financial sector, as well as the uncertain external environment. Sustained implementation of structural reforms would support diversification, external competitiveness and more inclusive economic growth. We are grateful to staff for the good report, and also thank Mr. Agung and Mr. Pham for their comprehensive buff.

Moderation of the current fiscal stance and the re-orientation of public spending would be warranted. The spending mix needs to be readjusted and geared towards infrastructure investments, education and health spending, to bolster economic development. We encourage the authorities to abstain from unsustainable public wage increases, and to strengthen control over the wage bill in the context of the ongoing public administration reform. Regarding revenue, we commend the good performance thanks to more effective tax administration. Nonetheless, further strengthening revenue should remain a priority, particularly given the solidifying middle-income status and the consequent decline in grants. As outlined by staff, tax policy reform would be beneficial. Going forward, the economy would benefit from strengthened institutional frameworks and governance, including for PPPs.

Vigilance is required against the build-up of financial sector risks. Banks are well capitalized, and profitable, as emphasized in the buff. However, credit to the economy has continued to grow rapidly, and the build-up of risks in the construction and real-estate sectors, including via the unsupervised lending by real-estate developers, calls for timely macro-prudential action. We thus welcome the measures taken by the authorities, as well as their consideration of further instruments to safeguard financial sector stability. Stepping-up the implementation of regulatory and market-based reforms to promote the use of domestic currency would also be beneficial.

The authorities should strengthen the AML/CFT regime. Shortcomings identified in the recent Asia Pacific Group on Money Laundering assessment should be expeditiously addressed. This would minimize the risks of a grey listing, as well as the loss of correspondent bank relationships.

We welcome the decline in inequality and poverty. However, a considerable share of the population continues to subsist just above poverty line. Continued reforms are thus called for to promote inclusive growth. Strengthening the rule of law, improving governance, and stepping up the implementation of structural reforms would support the investment environment, diversification and competitiveness, as well as more inclusive economic growth.

Mr. Lopetegui and Mr. Rojas Ulo submitted the following statement:

We thank staff for a clear and candid report and Mr. Agung and Mr. Pham for their helpful buff statement.

Cambodia’s economy continues to show an impressive economic performance. Over the last year, the economy has maintained strong growth led by garment exports, tourism, and the construction sectors, while inflation remains low. Economic growth is projected to continue with a robust dynamism, although it is subject to downside risks. We welcome the progress in income growth, poverty reduction, and diversification of the productive base. We concur with the report’s recommendation on the need to further structural reforms to improve productivity and increase competitiveness to sustain growth. While financed by large FDI inflows, the large current account deficit makes the economy vulnerable to external shocks.

The fiscal strategy needs to safeguard fiscal sustainability and the space to react to adverse shocks. The 2019 budget envisages a fiscal deficit higher than originally projected by staff, meaning that a further increase in public debt over time may materialize. While we agree that risks to fiscal sustainability remain contained in the short term, the country should not miss the opportunity to increase resilience to adverse external shocks, which are compounded by financial vulnerabilities at home. At the same time, in the absence of tax policy reforms, public revenue is projected to decline, and the authorities plan higher public investment which will reduce fiscal space, unless offset by lower current spending. The authorities should continue cementing a prudent fiscal policy with reforms to increase revenues, modernize revenue administration, prioritize public expenditures, and strengthen the management of public debt. Importantly, contingencies can be reduced with the strengthening of the PPP framework.

High dollarization, a strong real-estate sector, and credit concentration result in financial vulnerabilities and call for further actions to increase resiliency. Financial stability indicators such as capital adequacy have strengthened, although profitability and non-performing loans could be improved. The authorities should continue monitoring the financial system since the staff report shows an elevated risk for concentration due to the increase of the flow of credit in the construction and real estate sectors, which is a key transmission channel linking credit with economic growth. We support staff's recommendation to contain real estate sector growth with prudential measures and introduce a crisis management framework. We encourage the authorities to continue efforts to address gaps in the AMF/CFT regime and more broadly, strengthen governance.

We support the implementation of structural reforms which helped diversify the economy and increase competitiveness. The country has made impressive reforms to a more manufacturing-based economy and improvements in labor productivity. Additionally, on the social front, Cambodia is close to eradicating absolute poverty, and progress has been made in human development. Nevertheless, structural constraints to increase potential growth remain, and reforms are needed to increase competitiveness and diversification. We encourage the authorities to focus on reducing energy costs, enhancing transportation links, developing human capital, and improving the business climate.

With these comments, we wish Cambodia and its people success in their future endeavors.

Mr. Gokarn and Ms. Dhillon submitted the following statement:

We thank staff for the excellent reports and Mr. Agung and Mr. Pham for their informative buff statement.

With rapid and durable economic growth, Cambodia is one of the fastest-growing economies in the world. Growth is expected to reach 7.25 percent, compared to 6.9 percent in 2017 backed by garment exports, tourism, construction and higher public spending. Strong economic indicators of the external position, FDI inflows and foreign reserves are reassuring. However, challenges remain, including from reliance on external funding, the business environment and economic diversification. Externally, weaker growth in the advanced economies and China and protectionism pose risks. Going forward, success in addressing these challenges will rest on maintaining macroeconomic stability, increasing economic diversification and competitiveness. We agree with the thrust of the staff report and would like to offer the following comments for emphasis.

We join staff in underscoring fiscal sustainability. With an expansionary fiscal policy for supporting the reform agenda, the fiscal deficit could move upward and remain in a vulnerable space. This will require even stronger revenue collections, especially in the upcoming election scenario where spending pressures may dominate. Achieving high revenue collections is commendable and this could be sustained with further improvements in revenue administration, enhancing transparency and modernizing tax policy. We welcome all efforts of the authorities towards this. Separately, we note that investment financed by Public – Private Partnerships (PPP) has grown and Cambodia now stands as a leader relative to its peers. Given the related risks from contingent liabilities and off-balance sheet obligations arising from PPPs, we would, like staff, urge the authorities to strengthen the PPP framework.

Cambodia's financial sector continues to grow strongly, with more financial inclusion. Reducing risks emanating from credit quality, real-estate sector concentration and reliance on external funding could be furthered through robust monitoring, reinforced regulation, data collection and well targeted macro-prudential policies, many of which are being encouragingly prioritized by the authorities. We also welcome steps taken by the authorities to promote inclusion. While acknowledging the staff recommendations, the authorities have emphasized the broader importance of the banking sector's credit in supporting growth amidst development challenges. The staff recommendations in Text table 2 on Safeguarding Financial Stability are extensive including a comprehensive crisis management framework. Could the staff elaborate on a) the desirable sequence and timelines of these recommendations for managing credit growth and real estate sector risks b) the impact on growth if the suggested measures are not implemented in the medium term? Beyond this, we would encourage expediting the implementation of outstanding FSAP recommendations and addressing shortcomings in the AML/ CFT framework.

Structural reforms are paramount for sustained and inclusive growth and we welcome the efforts of the authorities to support education and skills, small and medium enterprises for economic diversification and job growth. In line with staff advice, the authorities have also recognized the need to improve the business climate, efficiently provide public goods and services, and to improve governance. Going forward, we remain assured of the Cambodian authorities' reform agenda to advance growth prospects. As with the previous report, we note that the staff have underscored climate change spillovers and suggested design of macroeconomic and structural policies to improve resilience. Could staff elaborate on the incremental steps taken by the authorities to meet this objective since the last report?

Finally, as a general suggestion, we would request staff to include an annexure of the capacity development initiatives of the Fund, including those in the pipeline, in all Article IV reports, for a better appreciation of the work in this area.

With these remarks, we wish the authorities the very best in their endeavors.

Mr. Alkhareif and Mr. Rawah submitted the following statement:

We thank staff for the well-written report and Mr. Agung and Mr. Pham for their helpful buff statement. We broadly share staff conclusions and policy recommendations and would like to make the following points for emphasis.

We take positive note of Cambodia's impressive growth performance. In this context, the authorities should remain focused on further supporting inclusive growth while safeguarding fiscal sustainability, managing macro-financial risks, and addressing governance vulnerabilities. Here, we appreciate the authorities' emphasis in these challenges, as noted in the buff statement. We would also encourage the authorities to accelerate the needed structural reforms to continue to improve economic and social infrastructure, especially in rural areas where gaps remain.

We encourage the authorities to reorient expenditures toward growth-enhancing infrastructure and other priority spending including health and education sectors. Like staff, we would like to underscore that importance of better budget execution including through integrating the medium-term fiscal framework (MTFF) into the budget process and developing a medium-term budgetary framework. We also welcome the steps taken to develop a public debt management strategy (PDMS), which is indeed critical to strengthen risk management especially in the context of materialization of contingent liabilities as well as export and growth shocks. In addition, efforts on enhancing fiscal governance should be sustained.

Finally, as rightly noted by staff, further policy measures are warranted to tackle elevated financial sector vulnerabilities. In our view, it is essential to continue to upgrade the regulatory and supervisory frameworks while addressing the remaining AML/CFT regime gaps to avoid a possible FATF listing. Also, we welcome NBC's efforts to mitigate financial stability risks as outlined in the buff statement. In addition, we encourage the authorities to closely monitor the construction and real estate sector risks and to remain vigilant to vulnerabilities stemming from high credit growth.

With these remarks, we wish the authorities further success.

Mr. Moreno and Ms. Mulas submitted the following statement:

We thank staff for its report and Mr. Agung and Mr. Pham for their candid buff statement.

Notwithstanding the shortcomings in governance, Cambodia has enjoyed strong economic performance during the last two decades. Cambodia's economic growth has been one of the fastest among Asian developing countries, driven by vibrant garment exports, the fast-growing real estate, construction, and tourism sectors. As a result, Cambodia has achieved lower middle-income status. We encourage the authorities to use good times to pursue structural reforms, continue upgrading human capital, and promoting a stronger rule of law.

The strong economic performance has resulted in a substantial reduction in poverty, but inequalities remain. Despite impressive poverty reduction with absolute poverty declining to only 2 percent, a significant share of the population still lives just above the poverty line. Therefore, we encourage authorities to adopt reforms to promote inclusive growth, particularly addressing skill gaps via improving the quality of education and promoting technical and vocational training. As the staff report note, there is also room for fiscal policies to better support inclusion, through shifting tax policies towards more progressive revenue sources and increasing spending on infrastructure, while improving spending efficiency.

The near-term outlook remains broadly favorable and growth is projected to remain robust, but risks are skewed to the downside. Cambodia's economic performance is susceptible to external shocks, given the narrow export base and a large external current account deficit. Trade sanctions stemming from international concerns about political developments could hamper exports and foreign direct investment, and dent confidence. Could staff elaborate on the economic impact of a possible withdrawal of Cambodia's Everything But Arms preferences (EBA), which guarantees completely tariff-free access to the European market for all exports except for weapons and ammunition?

Rapid credit growth has resulted in the accumulation of financial sector vulnerabilities, driven by concerns over credit quality, growing exposure to the real estate and construction sector, reliance on external funding and growing importance of micro-finance institutions. Besides, recent data have indicated that the central bank's effort to curb the pace of credit growth have had a weaker effect than expected. The recent measures are welcome steps, however further efforts are required to bolster financial stability and resilience. Considering Cambodia's dollarized economy, we consider it important to develop a well-sequenced set of micro- and macro- prudential tools and to continue upgrading the regulation and supervision sector.

The final 2019 budget projects higher current expenditures than previously foreseen despite staff's recommendation to restrain them. As a result, the deficit for 2019 is expected to reach 3.7 percent compared with a staff projection of 3.3 percent of GDP in the staff report. Authorities highlighted in the staff report that the 2019 budget law is geared towards consolidating by restraining current spending. Staff's comments are welcome.

We welcome authorities' commitment to make all the efforts in complying with international standards, including addressing shortcomings in the Anti-Money Laundering and Counter Financing of Terrorism (AML/CFT) regime and building the Financial Intelligence Unit's (FIU) Capacity. To this end, we agree with staff's appraisal that policies need to address shortcomings identified by the Asia Pacific Group on ML and demonstrate progress to avoid public Financial Action Task Force (FATF) listing.

Mr. Beblawi and Ms. Al-Riffai submitted the following statement:

Cambodia's economic growth and reform record has been impressive. As noted in Mr. Agung and Mr. Pham's informative buff, the country has sustained growth of around 7.7 percent since 1995 and is the 8th fastest growing economy world-wide. Economic activity in 2018 is expected to remain strong, driven by construction, tourism, exports, and expansionary fiscal policies, while inflation is expected to remain low. The discussions appropriately focused on risks related to a buildup of financial sector vulnerabilities, safeguarding fiscal sustainability, the possible materialization of contingent liabilities, and supporting inclusive growth. We broadly concur with staff's views and have the following to highlight.

Cambodia's public debt remains low and we note the broad agreement between staff and the authorities on safeguarding fiscal sustainability over the medium-term. To this end, we commend the authorities on their progress towards introducing a medium-term fiscal framework and look forward to the completion of the medium-term budget framework. On the spending side, we share staff's view of restraining current spending as well as prioritizing infrastructure and development spending in line with the authorities' National Social Protection Policy Framework. Additional wage increases should be performance based, applicable to priority sectors, and contingent on maintaining adequate fiscal buffers. We look forward to the completion of the new Revenue Mobilization Strategy which incorporates Fund technical assistance recommendations.

We welcome the steps the authorities are taking to safeguard financial stability, nonetheless, macro-financial vulnerabilities are growing. Cambodian banks are adequately capitalized; but, their profitability has declined, and while NPL levels are low, they may be understated due to inadequate loan classification. We thus, positively note the authorities' phased implementation of a capital conservation buffer and encourage them to expedite the completion of the planned improvements in bank loan classification. We look forward to the authorities effectively implementing past measures to address vulnerabilities and their introduction of additional targeted prudential measures—such as raising risk weights for real-estate lending—and a crisis management framework with a deposit insurance scheme.

The high and growing exposure to the real-estate sector has seen credit growth averaging around 35 percent since 2016. We encourage the authorities to move forward with monitoring and regulating lending by real-estate developers in line with other non-bank credit providers, and introducing aggregate loan-to-value limits and industry-wide real-estate valuations would be helpful. We look forward to the completion of the legislation on real-estate activity that would lead to improving oversight of real-estate activity. We note that the lack of complete and reliable data on the housing and real-estate sectors has been cited as a longstanding challenge across several previous staff reports, can staff clarify how this will be addressed in the forthcoming legislation?

We take note of the positive contribution that microfinance institutions (MFIs) have had on expanding access to finance, but its share is growing, and MFI credit growth now exceeds 30 percent. We concur with staff that the interest rate ceiling imposed on MFI's in 2017 may encourage informal financing. We welcome the authorities' intention to monitor the impact of the interest rate cap and see merit in gradually phasing out the interest rate ceiling on MFIs and aligning their sectoral loan classification with that for banks. Can staff comment on the estimated share of MFI and informal (money lender) loans in total loans?

Cambodia has made significant progress towards strong growth and poverty reduction. Providing the necessary infrastructure, improving competitiveness, and encouraging private sector involvement can positively contribute to inclusive growth. Given the increased reliance on using PPPs to finance investment projects, we welcome the authorities' roadmap to have a well-designed legal and institutional framework for PPPs firmly in place by 2020 to safeguard against risks.

We wish the Cambodian authorities further success in their reform efforts.

Mr. Kim, Mr. Shin and Mr. Kim submitted the following statement:

We thank staff for their comprehensive report and Mr. Agung and Mr. Pham for their informative buff statement. Cambodia has achieved solid economic performance attributable to garment exports, tourism, and construction. We take a positive note that Cambodia's per capita GDP, as one of the fastest-growing economies, has outpaced the comparable developing economies and its absolute poverty has been reduced remarkably. However, we also note that uncertainties remain elevated in terms of financial sector vulnerabilities, spillovers from trade tension, and rising global interest rate. We agree with the thrust of the staff appraisal and add the following comments for emphasis.

Building fiscal buffers should be at the center of the policy efforts in face of growing downside risks. We welcome that the budget policy will divert from fiscal easing next year by restraining current spending and commend the authorities for making progress towards introducing a medium-term fiscal framework with debt-based fiscal anchor. While noting that Cambodia remains at low risk of external and overall debt distress in staff's DSA analysis with strong revenue performance, we agree with staff's risk assessment that there is a high possibility of a revenue shortfall in the future and that there will be a need for improved debt management framework including contingent liabilities incurred from public guarantees.

We share staff's view that managing macro-financial risks must be highly prioritized. Cambodia's expansionary monetary policy has successfully supported economic growth with low inflation to date. But, financial sector vulnerabilities including construction and real-estate sector risk has elevated in this process. In this vein, we agree with staff' view that further targeted macro-prudential measures will be warranted. Furthermore, we note that the interest rate ceiling introduced last year (i.e. at 18 percent on MFI lending) may result in reduction in financial access, encouraging informal borrowing and thereby weakening transparency. We would like to request staff's view and their main recommendations on this issue.

Structural reforms need to be accelerated for stronger competitiveness, diversification, and inclusive growth. We welcome that the authorities are committed to pushing forward the necessary structural and governance reforms to achieve their target of 7 percent growth over the medium-term. We concur with staff's view that there is room to better support inclusion through progressive taxes, infrastructure expenditure, and health and education spending, as shown in Box 3. On governance and corruption issue, while appreciating staff's endeavor to analyze the vulnerabilities in governance with low availability of data, we urge that the staff need to be very cautious in formulating policy recommendation, especially if they are based on third party indicators. In this vein, we wonder if sufficient discussion on use of related data were made with the authorities, taking country specific factors fully into account. Staff's view would be welcome.

Mr. Daïri and Mr. Osei Yeboah submitted the following statement:

The Cambodian economy continues to make great strides towards achieving the Sustainable Development Goals (SDGs) with impressive growth performance and declining poverty rates. Helped by expansionary fiscal policies and strong external demand in 2018, the broad-based growth has continued at a robust pace amid subdued inflation. Public debt remains low, and international reserves are adequate. However, fiscal and external current account deficits have widened, and elevated financial sector vulnerabilities and governance weaknesses pose challenges to sustainable growth. Downside risks to the outlook also call for further efforts to consolidate public finances, strengthen the financial sector, and advance structural reforms. We concur with the thrust of staff appraisal.

The preliminary 2019 budget appropriately targets a lower deficit to support fiscal and debt sustainability. We welcome efforts to increase tax revenues, restrain current outlays, and reallocate spending towards health and education sectors. Given growing risks to fiscal sustainability over the medium term, efforts should continue to improve the efficiency and equity of tax policies, modernize revenue administration, strengthen public financial management, and contain the wage bill by targeting pay increases to priority functions and good performers. We agree on the need to guide fiscal policy by moving to a debt-based anchor and establishing a medium-term fiscal framework (MTFF), which should integrate into the budget process. While welcoming progress in enhancing coverage, quality, integrity, and timeliness of fiscal reporting, we encourage the authorities to further improve fiscal transparency and governance, in line with Fund TA recommendations, and to strengthen the institutional framework for PPPs.

The banking system appears sound with adequate and increasing capital buffers, and NPLs are low. However, profitability has declined, NPLs have edged up recently, and vulnerabilities remain, including from continued reliance on external funding, increasing household and corporate leverage, and high credit growth concentrated in the construction and real estate sectors. We welcome efforts to safeguard financial stability through the phased implementation of a capital conservation buffer, introduction of a liquidity risk management framework, improvements in banks' loan classification, and revisions to provisioning rules. These should be complemented by raising reserve requirements on FX lending, increasing risk-weights for banks' real-estate related lending, and better regulating and monitoring lending by real-estate developers. However, we urge caution in policy formulation and implementation, given that significant data gaps complicate the proper assessment of risks.

Despite commendable gains to date in income growth and poverty alleviation, accelerated implementation of structural reforms to close infrastructure gaps, enhance human capital, improve the business climate, and develop financial markets is needed to increase competitiveness, encourage diversification, and sustain high growth and reduce income inequality. Lowering energy and logistics costs, further upgrading human capital, setting up an SME bank and entrepreneurship fund to promote SMEs, and adopting a competition law, as intended, go in the right direction. We are also pleased to learn from Messrs. Agung and Pham's helpful statement that addressing governance weaknesses and corruption vulnerabilities remains a strategic priority for the new government.

We wish the authorities continued success in their endeavors.

Mr. Merk and Mr. Braeuer submitted the following statement:

We thank staff for this informative report and Mr. Agung and Mr. Pham for their insightful buff statement. We generally concur with staff's assessment. Cambodia has seen years of impressive economic growth and reforms. However, going forward elevated financial sector vulnerabilities, development spending needs and governance weaknesses pose challenges for further advancing sustainable growth and development. Strong near-term economic performance provides a window of opportunity for necessary structural and governance reforms that would help sustain medium term growth.

Regarding fiscal policies, the authorities plan for current spending restraint is welcome. However, we agree with staff that more can be done to safeguard fiscal sustainability and support inclusion. As, absent tax policy reforms, revenue growth is expected to slow, we encourage the authorities to continue developing a Revenue Mobilization Strategy focusing on improving efficiency of tax policies and modernizing revenue administration in line with Fund TA recommendations. On the expenditure side, public wage increases should balance pay incentives and safeguarding fiscal sustainability.

While staff currently assesses debt risks to be low, the debt to GDP ratio is expected to rise significantly during the next decade. Against this background, we welcome staff's recommendation of introducing a medium-term debt ceiling. We agree that contingent liabilities need to be closely watched and encourage authorities to better manage fiscal costs and risks by strengthening the PPP framework.

Further policy measures are needed to address elevated financial sector vulnerabilities. Addressing risks stemming from the real-estate sector calls for a broader policy response, including strengthening monitoring and regulation. We welcome the authorities' commitment to address shortcomings in the AML/CFT regime. Nevertheless, we note from the Risk Assessment Matrix that Cambodia faces a high risk of a FATF listing and join staff in encouraging the authorities to take pre-emptive steps to cope with the possible loss of correspondent banking relationships.

We encourage the authorities to accelerate the implementation of structural reforms aimed at supporting inclusive growth. The authorities should increase competitiveness and encourage diversification, including through addressing the skills gaps via improving the quality of education as well as promoting technical and vocational training. While we welcome the steps taken to strengthen anti-corruption efforts, we support staff's call for further advances.

Cambodia is a heavy CD user and we are encouraged to see that many TA recommendations seem to have been incorporated into the surveillance work and the policy recommendations. We join Ms. Pollard in commending staff for the very helpful annex on capacity development, including a multi-year strategic surveillance and CD matrix.

Mr. Palei and Ms. Smirnova submitted the following statement:

We thank staff for the comprehensive report and Mr. Agung and Mr. Pham for their informative BUFF statement. We broadly concur with staff's assessment and policy advice and would like to underline the following points.

Cambodia is one of the fastest-growing economies in the world, with average annual growth rate at around 7 percent during the post-Global Financial Crisis (GFC) period. In 2018, the economy is expected to expand by about 7.25 percent, based on robust growth of garment exports, tourism, and construction. We welcome the authorities' efforts to carry out structural reforms and reduce poverty. At the same time, we note that current growth drivers depend heavily on external environment. The remaining vulnerabilities point to the risk of a major slowdown in response to possible adverse developments in the global economy.

In addition to Cambodia's reliance on external sources of growth, staff assessed current external position to be moderately weaker than implied by fundamentals. Under these circumstances, the managed exchange rate regime calls for additional buffers. Accordingly, we welcome the authorities' commitment to further increase foreign exchange reserves, which, according to staff report, may reach around US$9.6 billion by the end of 2018.

We agree with staff's recommendation to adopt a medium-term fiscal framework that uses macro-fiscal forecasts as a guide. Preparation by the authorities of a three-year spending plan, mentioned in the report, is a step in the right direction. The suggested reallocation of spending towards health and education sectors deserves close attention in order to ensure its efficiency. Can staff elaborate on the quality of the existing process of selecting specific programs or projects in these sectors? On the revenue side, this year's outcome benefited from one-off factors. We believe that the suggested tax policy reforms and the adoption of Revenue Mobilization Strategy aimed at raising permanent revenue base are essential for long-term financial stability.

We note that public debt in Cambodia is relatively low, only about 30 percent of GDP. At the same time, staff highlighted the risks related to contingent liabilities, which could increase public debt by about 11 percent. Can staff comment on the nature of these contingent liabilities and their possible triggers?

We are concerned about the risks to financial stability stemming from rapid growth of credit in the economy. We note that in the real estate sector mortgages are subject to looser lending conditions, and microfinance lending grows at a worryingly high rate of 30 percent. Despite recent progress in loans classification, the true level of non-performing loans may still be understated. We welcome the adoption of macroprudential measures, mentioned in the report. At the same time, we call for caution in response to accumulation of risks and stress the need to continue to enhance supervision in the financial sector.

We concur with the advice to diversify the economy and note that diversification is a challenging task. According to the report, staff believe that future economic activity will be driven by exports and tourism. At the same time, in the former Article IV reports, we read that during the past two decades, economic growth in Cambodia was based on three or four key sectors. Until 2009-2010 growth was driven primarily by garment exports, tourism, and agriculture. After 2010 it was mostly driven by garment exports, tourism, construction, and real estate. The growing sectors have attracted significant FDI inflows. In the informative BUFF statement Mr Agung and Mr. Phan emphasized that the Cambodian authorities expect to continue to attract FDI in the medium term. In this respect, have staff and/or the Cambodian authorities elaborated any comprehensive diversification strategy? Are there any specific plans to diversify exports and participate more actively in the global value chains? Could staff also elaborate on why agriculture is not considered as a driver of growth anymore?

Ms. Levonian, Ms. McKiernan and Mr. Sylvester submitted the following statement:

We thank staff for their useful set of papers and Messrs. Agung and Pham for their candid buff statement.

We broadly concur with the main thrust of staff's appraisal and recommendations. We commend the Cambodian authorities for the significant progress made over many years towards the achievement of the Sustainable Development Goals (SDGs). While the medium-term prospect is favorable, it is constrained by growing downside risks and vulnerabilities. In this context, the key policy priorities going forward should focus on safeguarding fiscal sustainability, managing macro-financial risks, supporting inclusive growth, and addressing governance vulnerabilities and corruption. We offer the following additional comments for emphasis.

We support planned efforts by the Cambodian authorities to safeguard fiscal sustainability. The authorities' intention to take action in line with staff's recommendations to reform the tax system and improve the efficiency of public spending is welcome. Further, we are encouraged by their efforts to strengthen the management of public debt and contingent liabilities as well as undertake reforms to bolster public financial management. We urge the authorities to use fiscal reforms as an opportunity to advance inclusive growth.

We stress the importance of further macroprudential reforms to address elevated financial sector vulnerabilities. We commend the Cambodian authorities for their strong efforts on financial sector stability, including to promote financial market development. However, financial sector vulnerabilities are elevated, including those related to the real estate sector and the AML/CFT regime. We encourage the authorities to continue to implement required reforms to bolster financial sector stability and resilience.

The Cambodian authorities are urged to accelerate structural reforms to further support sustainable and inclusive growth. Cambodia has made significant social and economic progress over recent years, including progress on economic diversification. That said, further reforms are needed to cement these gains and to make further inroads towards the achievement of the SDGs. We welcome the authorities' planned efforts aimed at, inter alia, improving the business environment, promoting entrepreneurship, and improving health and education outcomes. We also welcome their emphasis on addressing governance vulnerabilities and corruption.

Mr. de Villeroché, Mr. Castets and Mr. Sode submitted the following statement:

We thank staff for the quality of their document and Mr. Agung and Mr. Pham for their insightful buff statement. Cambodia experienced a sustained growth pace during the last two decades that allowed a significant reduction of poverty and increase of the GDP per capita. Integration to international value chains and economic diversification have been key drivers of this good macroeconomic performance. Going forward, continuous economic reforms appear warranted to pursue on this upward economic trajectory. As we broadly agree with staff's assessment and recommendations, we would like to underline the following points for emphasis:

On the growth outlook, we wonder whether staff assessed the impact of potential trade sanctions currently under discussion at the US and EU levels. Given the importance of the cost competitiveness channel for the Cambodian export-driven growth model, envisioned sanctions, which could curtail preferential trade access, could have significant impact on the export sector. Staff comments are welcome.

On fiscal policy, we welcome the intention of the authorities to change course after the procyclical fiscal stance adopted in 2018 and to reduce the public deficit in 2019. Preserving fiscal sustainability and creating fiscal space to finance development needs imply higher tax revenues as well as more efficient spending. We are encouraged by the announced efforts to curtail current spending and the adoption of the Revenue Mobilization Strategy II, as indicated in Mr Agung and Mr Pham buff statement. Going forward, we encourage the authorities to consider staff's recommendations on further tax reforms that would allow for enhancing tax progressivity while creating fiscal space to finance development needs (well detailed in Box 3). We also support staff's calls for further improving the public financial management framework, notably on accounting practices, transparency and public investment management. Strengthening the regulatory framework for PPP contract will also be key to minimize contingent debt risks going forward.

On financial stability, we agree with staff that excessive credit growth, notably in the real estate sector, is a major source of concern. We support staff's recommendations to further strengthen financial supervision and to adopt short term measures to reduce risks, prioritizing the real estate sector (such as the introduction of a LTV requirement). Could staff indicate whether an assessment of NPLs is available when applying the internationally agreed definition? We also encourage the authorities to step up their efforts to improve the AMF/CFT framework along the recommendation of the Asia Pacific Group on money laundering. Going forward, structural financial reforms should aim at further developing domestic capital markets and decrease the dollarization of the economy.

In terms of structural reforms, we strongly support staff's recommendations to improve the regulatory framework, strengthen the business climate and adopt international best practices in terms of public procurement and PPP regulations. Improving economic governance in these areas and fighting corruption will be key to further attract foreign direct investments and diversify their geographical sources. Beyond governance, we also support staff's call for strengthening investment in human capital notably by improving the quality of the education system.

As discussed in the recent review of capacity development, we appreciate that Article IV reports better integrate prospective technical assistance into the surveillance analysis. In this regard, we thank staff for the annex on IMF TA and training in Cambodia. Could staff further elaborate on the main lessons learned from Cambodia experience in terms of TA modalities, prioritization and sequencing?

Mr. Jin and Ms. Lok submitted the following statement:

We thank staff for the comprehensive report, and Mr. Agung and Mr. Pham for their helpful buff statement. Impressive economic growth together with the authorities' reform efforts have contributed to considerable progress towards the Sustainable Development Goals (SDGs) in Cambodia. With growth expected to remain robust in the near term, we encourage the authorities to take the opportunity to advance further macroeconomic and structural reforms to strengthen the economy's resilience against external shocks and achieve sustainable and inclusive growth.

Efforts are needed on both the expenditure and revenue sides to meet development needs while ensuring fiscal sustainability. Priority should to be given to productive infrastructure and human capital investment, and we take positive note that the 2019 budget includes a reallocation of spending towards the health and education sectors. Compared to the preliminary budget, the final 2019 budget envisions additional spending, and projects a higher fiscal deficit of 3.7 percent. What are the reasons for the changes in the estimates on the revenue side? We support the authorities' efforts in developing the Medium-Term Fiscal Framework and Revenue Mobilization Strategy with the Fund's technical assistance, which will help strengthen fiscal management and enhance efficiency going forward. Meanwhile, as the share of public-private partnerships (PPPs) is expected to increase, a stronger institutional framework for these partnerships would be needed. To this end, we welcome the authorities' progress in strengthening PPP-related risk management with the assistance from the Fund, World Bank, and ADB, as well as other efforts including the establishment of a central PPP unit and the development of a new PPP law.

We take positive note that the authorities are mindful of the heightened financial sector vulnerabilities, which call for a strengthened supervisory and regulatory framework and targeted prudential measures. The adoption of measures including the capital conservation buffer, a liquidity management framework, and improvements in banks' loan classification and provisioning rules is welcome. We encourage the authorities to keep a close watch on activities by both banks and non-banks, especially in the real-estate sector, where credit growth remains elevated and risks may have increased as a result of possible mortgage-lending with looser conditions by real-estate developers. To this end, we take comfort from the fact that efforts to expedite data collection in the real-estate sector are underway. Is there any rough indication on the scale of mortgage lending by real-estate developers? Is this lending covered in the authorities' data collection exercise? We welcome the authorities' efforts in tackling issues with the AML/CFT regime and encourage the Fund to provide further technical assistance in this area as needed.

Efforts to improve the business environment and promote diversification would help raise Cambodia's competitiveness, and we are encouraged by the authorities' commitment to addressing structural constraints to potential growth. We also welcome the authorities' anti-corruption efforts so far and take positive note that addressing governance weaknesses remains a top priority for the new government.

With these remarks, we wish the authorities every success with their policy endeavors.

The Acting Chair (Mr. Zhang) noted that Cambodia's economic progress had been impressive and the result of two decades of strong economic growth, during which time, Cambodia had attained middle-income economy status. He commended the authorities for their achievements in poverty reduction and the progress made toward achieving the Sustainable Development Goals (SDGs). He remarked that challenges remained, particularly with regard to fully unlocking Cambodia's growth potential.

Ms. Mannathoko made the following statement:

We thank the staff for the report and the helpful comments in the buff statement. We commend the Cambodian authorities on the significant measures they have undertaken and the strong performance. However, we wanted to add a few thoughts. Given the emergence of some adverse trends, such as the slowing down of government investment and rising wages, the authorities may want to pay attention to the issue of preserving competitiveness, especially through measures to boost productivity to help contain labor costs given the upward trend in real wages. They may even consider pairing wage growth with productivity growth. This would help free more resources for the infrastructure and human capital developments that they have proposed. We agree that these priorities are critical in helping Cambodia to advance along the path of structural transformation.

We also support the prioritization of the diversification agenda, especially given the current external environment, and the global uncertainty given the potential for new shocks. We support the staff's proposal to build up the reserve buffer in order to ameliorate these risks.

With regard to the risk of a sizeable correction in real estate prices, we also support the suggestion to beef up prudential measures in order to safeguard stability.

Finally, we also encourage the implementation of more Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) reforms.

Mr. de Villeroché praised the report's approach to governance issues, and fully supported the multipronged recommendations aimed at improving transparency of public finances, the public-private partnership (PPP) framework, the forthcoming legislation, the AML/CFT regulations, and the business climate. He remarked that it was important for

Article IV reports to deal with such issues and cited the staff report as a model for other Article IV reports.

Mr. Saito made the following statement:

We thank the staff for the comprehensive report and Mr. Agung and Mr. Pham for their informative statement. We are pleased to see that Cambodia has enjoyed average growth rate of about 7.7 percent for the past two decades, the eighth-fastest growing economy in the world, according to the buff statement. I have issued a gray statement and would like to offer a few comments for emphasis.

First, on fiscal policy, we commend the authorities' efforts in enhancing the revenue collection, which has helped contain the fiscal deficit. We also welcome the 2019 budget law that will deepen consolidation by restraining current spending. Going forward, we encourage the authorities to develop the medium-term fiscal framework, which could help safeguard infrastructure and development spending over the medium term. We believe that Fund advice and technical support continue to be valuable in this area.

Second, on the financial sector, it is encouraging that the Cambodian banking sector remains sound and profitable with adequate capital buffers. On the other hand, we are concerned about high credit growth, especially in the real estate sector, and the credit of microfinance institutions. Therefore, we concur with the staff on the need to strengthen monitoring, and we support the authorities' initiatives to expedite data collection in the real estate sector. Also, we encourage the authorities to take further steps to strengthen the regulation and supervision of the microfinance institutions.

Finally, on dedollarization, given the highly dollarized economy, we agree with the staff that promoting the financial markets and encouraging local currency use would increase resilience. At the same time, as shown in the staff's response to our question, we recommend a gradual and market-driven approach to dedollarization so as not to undermine macroeconomic stability and low inflation.

Mr. Rashkovan made the following statement:

I also thank Mr. Agung and Mr. Pham for their informative buff statement and staff for their detailed report and the answers to the technical questions.

We concur with most of the key recommendations, in particular those related to fiscal matters and improving governance. But, for instance, introducing a medium-term fiscal framework and a fiscal anchor will likely improve performance of public finances in the medium term. Looking at the results of the Debt Sustainability Analysis (DSA), which we find useful, we remain concerned about the existing risks to fiscal sustainability despite strong growth prospects. We encourage the authorities to closely monitor developments linked to implicit liabilities.

More generally, we are encouraged by the report's finding that the income levels have increased, and important progress had been made in reducing poverty. We appreciate the staff's recent assessment of the challenges to sustainability, both in terms of fiscal developments and emerging issues.

Even though climate change was not mentioned in the main report this year, the staff followed up on the earlier recommendations issued in 2017, which we appreciate. We also appreciate the staff's clear answer to our technical question. We agree that climate-related risks can have non-negligible fiscal implications, notably when it comes to mitigation and adaptation costs. As climate-related risks, including extreme weather events, cannot be directly influenced by the authorities, or only to a minor degree, we also agree that these risks can or should be considered external.

Finally, we concur with the staff and many Directors that further efforts remain necessary to address governance and transparency challenges, which pose challenges for further advancing sustainable development, and like Mr. de Villeroché, we want to highlight the excellent work of the staff on governance issues.

Mr. Jin made the following statement:

I thank the staff for the detailed report, and Mr. Agung and Mr. Pham for the helpful buff statement.

I would like to commend the impressive growth achieved by Cambodia over the last two decades, averaging 7.7 percent per year, which is quite high. To extend this great track record, we encourage the authorities to keep up the reform momentum and address remaining challenges to promote long-term sustainable and inclusive growth.

We have already issued a gray statement, so I would like to make the following points. We thank the staff for the response to our question on mortgage lending by real estate developers and reiterate our strong support for the authorities' efforts to step up data collection in the real estate sector. We look forward to the successful development and the passage of legislation to strengthen the regulation and supervision of the activities in this sector and the introduced reporting requirements for real estate developers. Better data provide a basis for effective policy decision and formulation.

Thanks to its comparative advantage, Cambodia's government sector has become a key driving force for the economy over the years. In the face of falling total factor productivity (TFP) growth in recent years, we welcome the authorities' determination to address structural constraints to potential growth and diversify the economy. When talking about the government sector, we note with concern the potential negative impact to Cambodia's economy that may arise from the withdrawal of Everything But Arms (EBA) status by EU. The garment industry is highly labor intensive. The withdrawal of EBA will harm the lower-income segments of the economy. Overall, the current uncertainties surrounding trade and the broader economic outlook call for strengthened buffers to weather any potential external shocks that may arise. Could the staff comment on the role of intraregional trade for Cambodia and whether this could lend support to the economy in case the risk of any external, non-regional shocks materialize.

Mr. Shin made the following statement:

Looking broadly at the Cambodian economy from the perspective of balance of payments, it seems that the current account deficit is being financed by FDI inflows. Although FDI are relatively stable flows, there still can be a sudden stop or capital reversal from emerging economies in the case of global market turbulence, and history tells us that it is especially so if a country has a large current account deficit. In this context, we encourage the authorities and the staff to closely monitor the capital flows and prepare for a well-crafted contingency plan.

I have one question about dedollarization. Local currency is currently used only for small sum settlements. Since dollarization seems to have both merits and demerits for a converging economy, it would be good to hear from the staff on what specific basis dedollarization is pursued and why the staff thinks a gradual and market-driven approach would be feasible rather than active policy action. Also, we wonder if there is a timeline or any plan for Fund technical assistance on this issue.

Ms. Pollard made the following statement:

I want to agree with Mr. de Villeroché and Mr. Rashkovan about the staff's work on integrating the coverage of governance issues throughout the report. We found this incredibly helpful and would encourage this approach for other countries. We also want to praise the staff for the visibility of capacity development information in the Article IV documents, and note that the use of resident advisors appears to be getting good results, as the staff mentioned in the answers to the technical questions, and we believe this approach could potentially be used elsewhere in other low-income countries (LICs).

I want to welcome the attention the staff have given to risks from contingent liabilities from PPPs, as noted in their answers to technical questions, and underscore the importance of full debt data transparency, including of contingent liabilities. Finally, I want to reiterate the importance of attention to addressing AML/CFT deficiencies that could result in a Financial Action Task Force (FATF) listing and jeopardize Cambodia's correspondent banking relationships (CBRs). In this regard, we welcome the technical assistance that Fund staff are providing.

Mr. Daïri made the following statement:

Once again, I commend the authorities for their impressive performance, and I thank Mr. Agung for his excellent buff statement and the staff for their hard work and sound advice. Like Mr. de Villeroché, Mr. Rashkovan, and Ms. Pollard, I appreciate the cautious approach in dealing with the governance issues, which is well justified in most countries. I appreciate that the staff has avoided relying on third-party indicators (TPIs) but instead on issues that have been discussed with the authorities in the context of technical assistance missions. This is a sound approach that can be applied in other countries. Of course, the advice should be measured with appropriate wording. Sometimes strong wording in this area may trigger unwarranted concerns within the private sector. Progress expectations should be gradual and each step should strengthen what has been achieved earlier while avoiding unduly undermining private investment confidence.

Mr. Palei made the following statement:

I welcome the authorities' excellent performance in terms of rapid growth over a prolonged period of time, and also commend the staff for a good set of papers that focused on the key issues and the key policy challenges the authorities are facing.

On the treatment of the governance and corruption issues in the report, I welcome the reliance on technical assistance missions, especially in the area of fiscal governance and AML/CFT and also the fact that the Legal Department reacted to the request from the authorities for close engagement in this area of governance and corruption. One issue attracted my attention when I read the answers to technical questions, and that is related to dollarization in Cambodia. The staff believes that the approach to dedollarization should be gradual, and this contrasts with the experience of some other countries which embarked on a much more aggressive approach to dedollarization because they are facing risks of strengthening of the dollar and because their economies are subject to significant external shocks. I would like the staff to comment on why the authorities and the staff prefer a more gradual approach, instead of having a more aggressive treatment of dollarization.

The staff representative from the Asia and Pacific Department (Mr. Turunen), in response to questions and comments from Executive Directors, made the following statement:[1]

Let me start by thanking Mr. Agung and Mr. Pham for their buff statement and the Cambodian authorities for their hospitality and productive and candid discussions. I would also like to thank Directors for their gray statements and the supportive comments and questions. We have issued a brief staff statement to update the Board on the final budget that was recently approved by the National Assembly.

I have just a few comments. The final budget figures are close to the preliminary budget figures discussed during the Article IV mission but include some additional current spending. As expected, the authorities' plans, as also reflected in the final budget figures, are geared toward restraint in current spending. In particular, following large increases over the past few years, the budget suggests that current spending, including on the wage bill, will remain constant as a share of GDP next year. The relatively small upward revision in spending does not alter the staff's views on the macroeconomic outlook. However, the revision does underscore the need to restrain current spending and raise revenues to address medium-term fiscal pressures.

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

As usual, we have provided detailed responses to the technical questions, and let me address the few questions that came along. First, on regional trade from Mr. Jin, it is true that as of now, Cambodian exports rely on just a few main destinations, primarily the EU and the United States. In that sense, there is certainly room to improve regional trade and integration. There is a process ongoing in ASEAN precisely for that purpose, which includes reductions in tariffs in Cambodia as well. In that sense, we would see an increase in regional trade, that is a diversification in terms of both goods and export destinations, as a positive factor for Cambodia that would improve economic resilience.

Second, there were questions from Mr. Shin and Mr. Palei on dollarization. The fundamental reason for us recommending dedollarization is to arrive at a more robust monetary policy framework that would allow Cambodia to respond to shocks. We have advocated a gradual and market-driven approach; however, there are active steps that the authorities have taken and that we have supported to move forward in the dedollarization process. As an example, I can mention the requirement for 10 percent of bank loans to be denominated in local currency. This is a measure that is being implemented. Banks are required to meet this requirement by the end of 2019, so there is a timeline for this active policy measure. However, in terms of a gradual or a faster de-dollarization process, many countries have de-dollarized in the context of a crisis or stress scenario. At the moment, we do not see that as being the situation in Cambodia, so we believe that the authorities have to some extent the luxury of moving gradually. A gradual approach in this sense would also allow households, corporations, banks, to gradually adjust their economic positions.

Mr. Agung made the following concluding statement:

On behalf of my Cambodian authorities, I thank Directors for their thoughtful gray statements and useful comments, which I will convey to my authorities. Cambodia's economic performance continues to be robust with remarkable poverty reduction, as acknowledged by many Directors and the staff. Even though key decisions are still being undertaken, positive progress has been made, including those reflected in the recent economic developments. But like many other emerging economies, this is still an ongoing process where the results need time to materialize. In this regard, our authorities appreciate the support from the Fund in rendering policy advice, and we also take note of the concerns and useful recommendations pointed out by Directors.

My Cambodian authorities are also aware that there is no room for complacency and thus will remain steadfast in undertaking necessary reforms that would help make the Cambodian economy more resilient. Taking into account the policy advice from Directors and the staff, the authorities are committed to building on their achievements in promoting sustainable and inclusive growth through diversifying the economy, strengthening competitiveness, and promoting productivity.

With regard to financial stability and fiscal sustainability, the authorities appreciate Directors' recommendations and are fully committed to make further efforts to improve fiscal governance and transparency, as well as address financial vulnerabilities. The authorities are also committed to continue addressing shortcomings in their AML/CFT regime in order to eliminate the risk of a FATF listing. In this regard, the authorities welcome the Fund's support in implementing the recommendations of the FATF.

Finally, let me conclude by conveying the Cambodian authorities' appreciation to the Fund for the constructive engagement through policy advice and technical assistance that has helped Cambodia achieve high growth over the past years. The authorities look forward to continuing support from the Fund to ensure Cambodia's sustainable and inclusive growth. I would like to also thank the mission chief and his team, as well as management and Directors, for constructive discussion and recommendation.

The draft summing up was read.

Mr. Palei noted that the summing up raised several areas for governance reform, but remarked that all of them were based on TPIs. The staff report, however, emphasized fiscal transparency, which was based on technical assistance, AML/CFT, and regulations.

The Acting Chair (Mr. Zhang) noted that Cambodia is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed Cambodia's continued robust growth performance and low inflation as well as the progress made in poverty reduction. Directors encouraged the authorities to take advantage of the current strong economic environment to intensify policies and structural reforms to enhance the economy's resilience, safeguard fiscal sustainability and financial stability, address governance vulnerabilities, and support inclusive growth.

Directors welcomed the authorities' plans to restrain current spending and raise revenues. They supported the new Revenue Mobilization Strategy, which should focus on increasing revenues by modernizing revenue administration and reforming tax policies to improve their efficiency and equity. To help support growth and sustainable development, it will be important to re-orient the composition of public spending towards priority infrastructure investment, and health and education spending. Directors considered that public wage increases should better balance pay incentives and fiscal sustainability. Additionally, institutionalizing the Medium-Term Fiscal Framework would help safeguard infrastructure and development spending over the medium term. While noting that Cambodia remains at low risk of debt distress, they recommended close monitoring of risks stemming from the materialization of contingent liabilities, including from PPPs. In this regard, strengthening the institutional framework for PPPs will be important. Directors generally emphasized the need to continue to foster debt discipline to maintain debt sustainability.

Directors welcomed the policy efforts to safeguard financial sector stability. However, noting the elevated vulnerabilities, they stressed the need for additional targeted macroprudential measures. Directors highlighted that priority should be given to raising risk weights for real-estate lending, introducing a crisis management framework with a deposit insurance scheme, and continued upgrading of regulation and supervision. Addressing risks stemming from the real-estate sector warrants a broad policy response, including strengthening monitoring and regulation and phased increases in property taxes. Directors stressed the importance of addressing gaps in the AML/CFT regime and complying with FATF international standards.

Directors emphasized that steadfast implementation of structural reforms is essential to boost productivity, promote stronger growth, and make further progress on the Sustainable Development Goals. They encouraged the authorities to give priority to increasing competitiveness and promoting diversification. Reform efforts should focus on improving the business environment, reducing energy costs, enhancing transportation links, addressing skills gaps, and enhancing social protection policies. Directors noted that while progress has been made in improving governance, further governance and anti-corruption efforts, including improving fiscal governance and the regulatory environment, as well as strengthening the rule of law, are critical going forward.

It is expected that the next Article IV consultation with Cambodia will be held on the standard 12-month cycle.

APPROVAL: January 21, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. On the growth outlook, we wonder whether staff assessed the impact of potential trade sanctions currently under discussion at the US and EU levels. Given the importance of the cost competitiveness channel for the Cambodian export-driven growth model, envisioned sanctions, which could curtail preferential trade access, could have significant impact on the export sector. Staff comments are welcome.

2. Could staff elaborate on the economic impact of a possible withdrawal of Cambodia's Everything But Arms preferences (EBA), which guarantees completely tariff-free access to the European market for all exports except for weapons and ammunition?

- The possible withdrawal of Cambodia's EBA status was first announced in October, following the July general election. If the European Commission decides to partially or entirely suspend the agreement, the process is expected to take about 18 months.
- Cambodia has strong trade ties to the European Union (EU), which accounts for more than 30 percent of total exports. Reflecting improvements in preferential access to the EU market in 2011, Cambodian export growth surged to 32 percent. We would therefore expect that a reversal, i.e. loss of preferential access, would have a significant negative impact on exports, as well as on foreign direct investment and economic activity. In particular, preferential trade status is an important element underpinning the success of the garment industry in Cambodia. The garment industry is the single largest formal employer in Cambodia, providing over 600,000 jobs in more than 500 export factories, with production amounting to roughly 30 percent of Cambodian GDP and over 70 percent of Cambodian exports. It is estimated that the garment and footwear sector provide support to approximately 2 million people in Cambodia (about 14 percent of the population), many of whom live just above the poverty line and are vulnerable to income shocks.

3. In a similar vein, regarding the RAM we would like to ask staff why they classified extreme weather events as "internal risk"?

- According to established policy for the Risk Assessment Matrix (RAM), since the extreme weather risk is not included in the current G-RAM, it should be classified as a domestic risk. We agree that the risk could be viewed as external, but it is heightened by Cambodia's limited capacity to implement timely mitigation and adaption policies.

Fiscal Policies

4. ***Authorities* highlighted in the staff report that the 2019 budget law is geared towards consolidating by restraining current spending. *Staff's comments are welcome.***

- The authorities finalized 2019 budget law envisages current spending, including spending on compensation of employees, remaining constant as a share of GDP, compared to large increases over the past several years (by more than 3 percentage points since 2013). Staff welcome this planned restraint in current spending. Staff recommend the authorities to continue to restrain current spending over the next few years, with further wage increases contingent on maintaining adequate fiscal buffers and supported by on-going public administration reforms, while shifting the composition of expenditures toward more pro-growth capital and social spending.

5. ***The suggested reallocation of spending towards health and education sectors deserves close attention in order to ensure its efficiency. Can staff elaborate on the quality of the existing process of selecting specific programs or projects in these sectors?***

- Weaknesses in public investment processes were flagged in the PEFA 2015 assessment, where Cambodia was given a low 'D' rating for a lack of "use of competitive procurement methods." Further assessments have also revealed shortcomings in the legal and institutional framework including a lack of effective ex-post evaluation instruments. For government financed projects, public investment management is relatively weak when compared with externally financed projects. The authorities are aware of these shortcomings and are developing a Public Procurement Strategy to address these challenges. Staff recommends policies to improve public financial management (PFM), including steps that could be taken to strengthen procurement processes.

6. ***We welcome staff advice on a stronger fiscal anchor in the form of a public debt/GDP limit. Can staff comment on the authorities' interest in pursuing such a policy change?***

- The authorities are currently finalizing a medium-term fiscal framework, which will involve a credible, transparent and easily communicable fiscal policy anchor. The authorities recognize that a fiscal anchor based on a medium-term debt ceiling (set at 40 percent of GDP) would provide a more direct stabilizing component to fiscal policy than the current fiscal anchor based on a minimum level of government deposits.

7. ***How do staff assess the overall transparency of debt data, including access to concessional borrowing agreements?***

- Overall transparency of public debt data is considered broadly adequate, but should be improved in other areas, such as PPP and private debt, where additional data collection efforts are needed. Thanks to effective collaboration with the Ministry of

Economy and Finance (MEF), staff was provided detailed public debt data, including on borrowing terms (such as maturities and interest rates) for bilateral concessional agreements. Public debt data are also regularly published in the public debt bulletin available on the MEF website. However, the existing data gaps in the areas of PPP and private external debt create uncertainty about the government's exposure to contingent liability risks.

8. Staff's comments on the growing contingent liabilities and fiscal risks pertaining to the PPP program are welcome.

- The authorities are currently in the process of developing a new Medium-Term Debt Strategy. Staff strongly encourage the authorities to develop a risk management framework that (*i*) controls fiscal risks by limiting the present value of guaranteed payments; (*ii*) strengthens the institutional framework for PPPs by introducing a formal gateway process and ensures that PPPs are subject to the same planning process as all public investment projects; and (*iii*) provides for the MEF and the National Bank of Cambodia (NBC) to work jointly to monitor PPP-related risks.

9. Staff highlighted the risks related to contingent liabilities, which could increase public debt by about 11 percent. Can staff comment on the nature of these contingent liabilities and their possible triggers?

- The contingent liabilities included in the Debt Sustainability Assessment (DSA) relate to PPPs and the financial market. The magnitude of the shock was calculated using the standard calibration of the DSA template (35 percent of PPP stock and 5 percent of GDP for the financial sector). The main channel of the materialization of PPP contingent liabilities is through the financial guarantees (income, profit, rate of return) agreed at the time of the contracts. The financial sector contingent liabilities relate to the fiscal cost arising from a financial crisis (bank recapitalization, deposit insurance).

10. Could staff comment on the fiscal implication of a decreasing working-age population?

- Cambodia's population is relatively young and its working-age population will continue to grow. While the growth rate in the working-age population is projected to moderate from 2 percent to about 1½ percent per annum, the fiscal implications of population ageing are only a medium and longer-term policy concern.

11. What are the reasons for the changes in the estimates on the revenue side?

- The authorities' downward revisions to revenues, at about 0.1 percent of GDP, are small. The authorities have slightly revised up their projection for tax revenue growth and, by a larger margin, revised down non-tax revenues.

Financial Sector

12. Are, in staff opinion, the suggested macroprudential measures sufficient to provide enough safeguard to financial stability in case of a transition to a floating exchange rate regime?

- Staffs' view on macroprudential policies is formed under the assumption that the current managed float exchange rate regime is maintained. This policy is deemed currently appropriate given the high level of financial dollarization. Over time, as dollarization declines, capacity improves, and the economy diversifies, it would be appropriate to gradually introduce greater exchange rate flexibility to better absorb external shocks and thus enable implementation of an independent monetary policy. Increased exchange rate volatility would place more urgency on the macroprudential recommendations aimed at containing risks stemming from potential currency mis-matches and on policies promoting use of the local currency.

13. How do staff assess the adequacy of the authorities' supervision and regulation on micro-finance institutions compared with banks?

- The growing systemic importance of MFIs, including deposit-taking MFIs (MDIs), calls for strengthened regulation that prevents regulatory arbitrage. The authorities have taken several steps to better align regulation and supervision. However, staff recommends further steps, including aligning the sectoral loan classification with that for banks, abolishing the MFI interest rate cap, and increasing reserve requirements for foreign exchange liabilities. The authorities should also strengthen risk-based supervision of the most important MFI/MDIs and continue to build supervisory capacity to better supervise the large number of financial institutions.

14. The staff recommendations in Text table 2 on Safeguarding Financial Stability are extensive including a comprehensive crisis management framework. Could the staff elaborate on a) the desirable sequence and timelines of these recommendations for managing credit growth and real estate sector risks b) the impact on growth if the suggested measures are not implemented in the medium term?

- In the short run, the authorities should focus on (*i*) improving the sectorial classification of loans which would help implementation of higher risk weights on real estate lending, (*ii*) collecting more data on the real estate sector, and (*iii*) regulating shadow banking activities conducted by real estate developers. In the medium term, as real-estate and household balance sheet data is improved, property taxes should be increased gradually to help stabilize house prices, and LTV limits should be introduced.
- Failure to put in place pre-emptive macroprudential policies to curb financial sector excess, particularly in the real-estate sector, and build banking sector resilience increases the risk of a disorderly economic adjustment should financial and real-estate sector risks materialize. Cross-country evidence based on Fund research suggests the potential output loss from such events is between 5 and 8 percent of GDP.

15. We note that the lack of complete and reliable data on the housing and real-estate sectors has been cited as a longstanding challenge across several previous staff reports, can staff clarify how this will be addressed in the forthcoming legislation?

- The authorities have established a working group to collect real estate sector data and are preparing legislation to improve monitoring and regulation of the real-estate sector activity. While the legislation is still being prepared, we understand that it will provide the basis for strengthening regulation and supervision of the construction and real-estate sector and introduces requirements for the real estate developers to report on their lending activity and funding sources. It is expected that the regulation, once introduce, does not allow developers to provide mortgages directly, requiring them to work with banks instead. Other data collection efforts include: (*i*) the General Department of Taxes is in the process of revising property valuations for tax purposes; and (*ii*) the NBC has finished gathering data on loans to the real estate sector and transaction prices based on house and land sales. However, due to a lack of sufficient time-series the data are not yet functional as a measure of price trends over time.

16. Furthermore, we note that the interest rate ceiling introduced last year (i.e. at 18 percent on MFI lending) may result in reduction in financial access, encouraging informal borrowing and thereby weakening transparency. We would like to request staff's view and their main recommendations on this issue.

- The introduction of the interest rate cap at 18 percent has resulted in lower interest rates (but, anecdotally, at the cost of higher fees and thus less transparency about borrowing costs) and larger MFI loans on average. While more information is needed, evidence is consistent with the view that the interest rate cap has reduced access to smaller, higher-cost loans, particularly in rural areas where informal lending practices are also more common. International evidence also suggests that interest rate caps are not an effective tool to increase access to low-cost credit. Staff therefore recommends phasing out the interest rate cap and replacing it with fundamental reforms to reduce funding and operational costs, and to improve financial literacy and consumer protection instead.

17. Is there any rough indication on the scale of mortgage lending by real-estate developers? Is this lending covered in the authorities' data collection exercise?

- The authorities do not collect these data and developers are currently not required to report data on their lending activities. The authorities are preparing legislation to improve monitoring and regulation of the real-estate sector activities. While the legislation is still being prepared, we understand that it will provide the basis for strengthening regulation and supervision of the construction and real-estate sectors and introduces requirements for the real estate developers to report on their lending activity and funding sources.

18. Can staff comment on the estimated share of MFIs and informal (money lender) loans in total loans?

- The loans from MFIs make up around 20 percent of total registered lending done by banks and MFIs. In addition, it is estimated that around 20 percent of the poor population in Cambodia uses informal credit (based on Global Findex 2014), but, as this is an unregulated activity, absolute numbers on these loans are not available.

19. Could staff indicate whether an assessment of NPLs is available when applying the internationally agreed definition?

- In line with Fund TA, the NBC tightened the classification of non-performing loans in 2017. The new regulation introduced a distinction between ‘restructured’ and ‘refinanced’ facilities which was absent in the previous framework. It also introduced new requirements for loan classification and provisioning of refinanced and short-term loans. These changes in regulations will likely result in an increase in the overall level of non-performing loans reported by some institutions later this year.

20. We wonder why the FATF listing is included as an external risk in the Risk Assessment Matrix, as it seems to be an area where the authorities could have a direct impact by strengthening their AML/CFT framework. We would also appreciate if staff could elaborate on the most critical measures that are needed to avoid FATF listing.

- The potential FATF listing has been re-classified as a domestic risk, following established policy for the Risk Assessment Matrix (RAM).
- At this stage, the likelihood of listing is high, as in its latest meeting in October 2018, the FATF decided that an action plan will be drawn up for Cambodia based on the critical deficiencies identified in the APG Mutual Evaluation Report. Deficiencies include, but are not limited to, inadequate AML/CFT supervision of banks and non-financial reporting entities, weak implementation of AML/CFT controls in high risk sectors, insufficient money laundering investigations and prosecutions, poor entity transparency, and the low capacity of the Financial Intelligence Unit to produce analysis. The action plan will include milestones and timelines to address these deficiencies. If the authorities commit to the action plan developed with the FATF to address the deficiencies, Cambodia is likely to be placed on the FATF’s “gray list” in February 2019.

21. Staff’s comments on the implementation status of the Fund’s technical assistance recommendations on financial integrity issues, including AML/CFT, are welcome.

- Fund technical assistance is ongoing in Cambodia and covers four main work streams: (*i*) amendments to AML/CFT law; (*ii*) capacity building of Financial Intelligence Unit; (*iii*) risk-based AML/CFT supervision of banks; and (*iv*) development of an AML/CFT National Strategy. These work streams are intended to help Cambodia progress towards implementing key recommendations issued by the APG in its latest evaluation. The National Strategy work is nearing completion and publication is intended for early 2019. With the assistance of the Fund, the NBC has recently commenced risk-based AML/CFT supervision of banks, in terms of both off-site and on-site inspections. Further work is still needed to build the capacity of the FIU, including by increasing resources, to address concerns raised by the APG. Legal amendments introducing enhanced customer due diligence requirements for domestic politically exposed persons are in the process of being drafted.

External Sector

22. Can staff comment on whether substantial FDI is potentially feeding bubbles in the real estate and financial sectors? How resilient is the Cambodian economy to a slowdown in FDI flows?

- A large part of the current FDI inflow is linked to banking and real estate sectors. In the first half of 2018, net FDI inflow to the banking sector amounted to over US$600 million, growing by 30 percent compared to the same period last year, and amounting to around 40 percent of total FDI inflow. The real estate accounted for just over 10 percent of total FDI, and also grew by 30 percent in 2018H1.
- A substantial part of the banking sector FDI inflow can be explained by higher capital requirements for banks, thus helping enhance resilience of the financial sector to shocks. However, overall, FDI inflows over the past several years have helped fuel rapid real-estate construction and banking sector growth. Risks associated with these sectors are being exacerbated by still underdeveloped monitoring and supervision, especially in the real estate sector. A slowdown in FDI would have significant negative effects on the real, external and financial sectors.

23. We would welcome the staff's comments on the merits and demerits of de-dollarization as well as the appropriate pace of de-dollarization.

- The near-full financial dollarization leaves little room for independent monetary policy, and it increases banks' vulnerability to liquidity risks. It also exposes banks to foreign exchange risk especially as continued financial deepening implies that more credit is extended to borrowers with income in Cambodian Riel. At the same time, Cambodia has recently enjoyed macroeconomic stability and contained inflation under the near-full dollarization regime. In this context, staff recommends a gradual and market-driven approach to de-dollarization.

Structural Reforms

24. In this respect, have staff and/or the Cambodian authorities elaborated any comprehensive diversification strategy? Are there any specific plans to diversify exports and participate more actively in the global value chains? Could staff also elaborate on why agriculture is not considered as a driver of growth anymore?

- The authorities have introduced policy measures to improve the business environment and support export diversification. These include:
- The authorities' 2015 Industrial Development Policy (IDP) provides a comprehensive diversification strategy and aims to transform and modernize Cambodia's industrial structure. The IDP includes policy measures on investment promotion and the development and modernization of small and medium-sized enterprises (SMEs).
- SME Bank and Entrepreneurship Fund: the authorities are working to set up an SME bank and entrepreneurship fund to promote SME growth.
- Sub-decree on Tax Incentives for SMEs in Priority Sectors: tax incentives are provided to SMEs in priority sectors such as manufacturing, agro-business, and

enterprises participating in global value chains to promote job creation, improve local production and encourage export diversification.

- Cambodia Trade Integration Strategy 2014-2018[2]: The authorities have developed a strategy and roadmap that aims to address challenges in export competitiveness and participate more actively in the regional and global value chains.
- The agriculture sector makes up around ¼of nominal GDP and employment. However, the contribution of agriculture to real GDP growth has been modes and averaged only 0.2 percent since 2013 due to low productivity growth and intermittent poor harvests (primarily due to flooding). The authorities are implementing policies to enhance the productivity of the sector, including developing new export markets for rice and rubber, improving irrigation systems and reducing the cost of credit for firms in the sector.

25. Could staff elaborate the recent developments of private wages and their effects on competitiveness in terms of attracting the FDI in a manufacturing sector?

- Minimum private wages in the garment sector were recently raised to US$182 a month, with effect from January 2019, a 7 percent nominal increase. While the increase is smaller than increases over the past few years, the level of minimum wages is currently higher than in several regional peers, including Bangladesh, Myanmar and Lao P.D.R and comparable to minimum, wages in Vietnam. If not accompanied with structural measures to improve productivity and the business climate, as well as measures to reduce energy costs, enhance transportation links and address skill gaps, higher wages could have a deterring effect on attracting FDI in the manufacturing sector.

26. As with the previous report, we note that the staff have underscored climate change spillovers and suggested design of macroeconomic and structural policies to improve resilience. Could staff elaborate on the incremental steps taken by the authorities to meet this objective since the last report?

- In collaboration with the UNDP and other development partners, the authorities have developed a comprehensive climate change response plan, the Cambodia Climate Change Strategic Plan (2014-23), as well as corresponding sectoral plans (Climate Change Financing Framework) and established a committee charged with overseeing climate change developments and policies (National Climate Change Committee). The authorities have included climate change considerations into the design of program budgeting for line ministries. Relevant ministries are required to create a respective climate change strategy in line with the national strategy to support their program budget requests.

27. On governance and corruption issue, while appreciating staff's endeavor to analyze the vulnerabilities in governance with low availability of data, we urge that the staff need to be very cautious in formulating policy recommendation, especially if they are based on third party indicators. In this vein, we wonder if sufficient discussion

[2] http://www.kh.undp.org/content/dam/cambodia/docs/PovRed/Cambodia%20Trade%20Integration%20Strategy%202014-2018.pdf

on use of related data were made with the authorities, taking country specific factors fully into account.

- The discussions with the authorities have focused on areas where the Fund has had a close engagement with the authorities, including through extensive technical assistance (TA) over the past several years. In particular, rather than relying on third party indicators, in the areas of fiscal governance and AML/CFT, the staff report recommendations are based on expert recommendations from TA missions. Policy recommendations to strengthen anti-corruption efforts have also benefited from expertise from the Legal department (including during the mission) and close engagement with country authorities, which have helped in formulating appropriate and country-specific policy recommendations.

Capacity Development

28. Can staff comment on how resident advisors are being used in the Cambodia CD program?

- Resident advisors are an important part of Cambodia's CD program and greatly improve the effectiveness and efficiency of the CD results by facilitating TA design, providing ongoing training and advice to help authorities fully implement recent Fund recommendations, and by enhancing in-house capacity for policy analysis and reporting via hands-on training. There have been several successful examples where the presence of a resident advisor has enhanced capacity building:
- *Resident advisor on banking supervision* helped the authorities move toward risk-based supervision (RBS) by upgrading on-site examination and off-site supervision procedures and CAMELS rating framework; The advisor also aided in upgrading prudential regulations and enforcement framework to effectively implement RBS.
- *Resident advisor on financial stability* has: (*i*) enhanced the NBC's in-house capacity for financial stability analysis and reporting by focusing on data and information management and ways to enhance data quality and integrity; (*ii*) generated reliable financial soundness indicators and their analysis and interpretation in the context of financial stability assessment; (*iii*) introduced use of risk-assessment tools and methodologies (including stress testing and early warning indicators) to effectively analyze financial sector risks and present this analysis in the form of a Financial Stability Report; (*iv*) staff training on the use of these tools and techniques for financial stability analysis and reporting.
- *Resident advisor on macro-fiscal issues* is helping the MEF analyze key fiscal issues primarily by strengthening and institutionalizing MFPD's macro-fiscal function by building capacity in policy formulation and analysis. The advisor is also assisting in building the MFPD's overall institutional capacity and TA facilitation.

29. Could staff further elaborate on the main lessons learned from Cambodia experience in terms of TA modalities, prioritization and sequencing?

30. We wonder if this is not stretching the absorption capacity of the country authorities and would appreciate staff's comments.

- Among the donor community, Cambodia is considered a successful case of TA delivery and the Fund's past engagement has successfully raised the level of capacity in Cambodia. The authorities are highly appreciative of the TA while noting their impacts and continue to demand further TA in key areas. Successful CD has been achieved using 3 key principles:
- *Close alignment between authorities demands and TA provision.* The close alignment and coordination between surveillance and TA has supported progress. As economy evolves, Fund CD needs to adjust to changing surveillance priorities. Area departments have regularly interacted with ICD to align surveillance and CD priorities, such as in financial surveillance and risk analysis.
- *Medium-term view*. TA design has taken full consideration of authorities' absorption capacity, their own demands for TA, and time required to instill a broad-based reform agenda. For example, moving from compliance to the implementation of risk-based supervision typically requires medium-to-long term TA engagement. A phased approach to TA delivery allowing adequate time for essential infrastructure work to take hold (i.e. regulations) help concentrate efforts efficiently.
- *Flexibility in delivery.* Fund CD in Cambodia is typically delivered through a combination of HQ-based missions, resident LTXs, CDOT-based advisors, and STXs. Activities included half-yearly review missions by FAD/CDOT, regular short-term expert (STX) visits and targeted workshops and training. Timely responses and flexible schedule have supported effective TA delivery, as recently requested by the NBC on the monetary operation project.