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Cambodia: Selected Issues

INTERNATIONAL MONETARY FUND

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CAMBODIA

SELECTED ISSUES

December 2022

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November 8, 2022

Approved By
Asia and Pacific Department

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RISKS RELATED TO PRIVATE SECTOR DEBT[1]

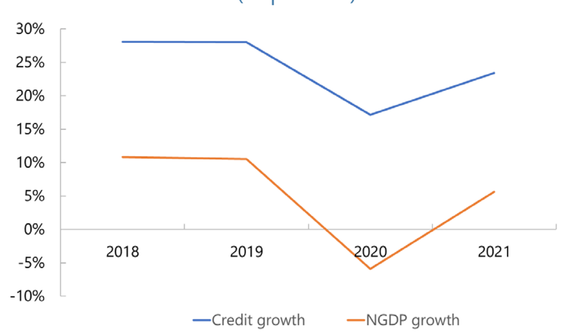
Private debt recorded double-digit growth rates for many consecutive years, exceeding by far the growth rate of output. Credit growth continued to be sustained even during the 2020 recession. Private sector debt is now expected to exceed 180 percent of GDP by the end of 2022. This ratio is significantly above levels registered among regional peers, even those with higher per capita GDP. While Cambodian households are increasingly leveraged, the largest share of private debt pertains to the corporate sector. Corporate debt is not concentrated in real estate, but rather is broadly distributed, with a large and increasing share pertaining to companies active in trade (retail and wholesale). 10 percent of the overall stock of private debt (17 percent of GDP) has been restructured at least once between 2020 and 2021, indicating the potential for sizeable stress to lenders if these loans required to be written off entirely.

A. Rising Private Sector Debt and its Composition

1. Private sector credit has been growing at a faster pace than nominal output and deposits for several consecutive years. Double-digit growth rates continued even in 2020, despite the recession. Before the pandemic, credit was growing above 25 percent a year, almost three times the rate of nominal output growth; even during the 2020 recession and the slow-paced recovery in 2021, credit growth to the private sector has been in the double digits. By the end of 2021, 87 percent of private debt was denominated in foreign currency (predominantly USD). Given the high rate of dollarization, most deposits are also USD-denominated (83 percent); but the FX loan-to-deposit ratio has been steadily increasing since 2018.

Figure 1. Cambodia: Private Sector Credit Growth and NGDP Growth (y-o-y)

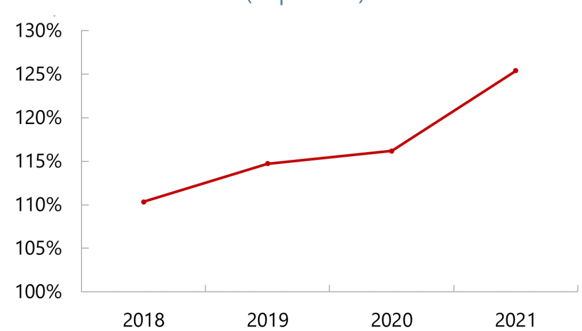
(In percent)



Sources: IMF staff calculations based on NBC and NIS' data.

Figure 2. Cambodia: FX Loan-to-Deposit Ratio

(In percent)



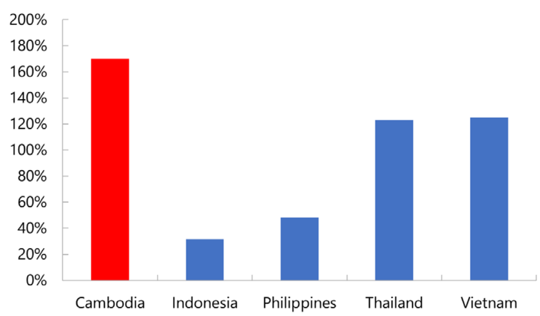
Sources: IMF staff calculations based on NBC data

[1] This annex was prepared by Alessia De Stefani and Luisa Zanforlin.

2. **The stock of private debt in Cambodia is very high by international standards.** Debt kept rising also in 2020 and 2021, despite the recession and the relatively slow pace of the recovery. Private debt levels in Cambodia were 170 percent of GDP by the end of 2021, exceeding by a wide margin the ratios registered in other low and middle-income countries in the region. By the end of 2022, outstanding credit to the private non-financial sector is expected to surpass 180 percent of GDP, continuing a steep trend of private debt accumulation observed over the past few years.

Figure 3. Cambodia: Private Sector Credit to GDP Compared

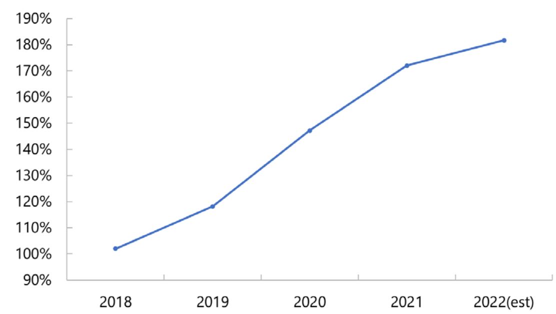
(In percent, 2021)



Source: IMF staff calculations based on NBC data and Systemic Risk Tracker.

Figure 4. Cambodia: Private Sector Credit

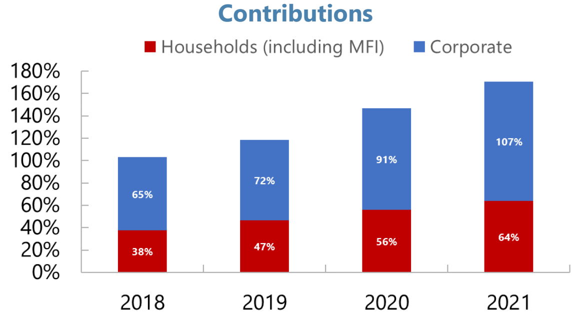
(In percent of GDP)



Sources: IMF staff calculations based on NBC data

3. **Most debt is concentrated in the corporate sector and sits in commercial banks, rather than in microfinance institutions.** Between 2018 and 2021, the ratio of total credit to output grew by 72 percentage points—in absolute terms, most of the increase can be explained by the rise in corporate credit, which increased by 42 percentage points, reaching 107 percent of GDP in 2021. By comparison, the 26 percentage points increase in household liabilities (including mortgages, personal loans, credit cards, and all MFI borrowing) is more modest, even if outstanding levels are still relevant. In terms of lending institutions, commercial banks are by far the largest players, holding 83 percent of the US$ 45 billion outstanding at the of end 2021. Not much information is available on the composition of credit held by microfinance institutions (MFIs). However, from the point of view of systemic risk, the role of MFIs is comparatively limited, as these institutions hold less than 17 percent of all outstanding credit, or US$ 7.8billion.

Figure 5. Cambodia: Private Sector Credit Contributions

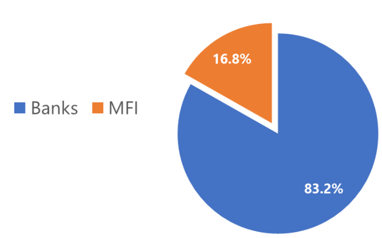


Source: IMF staff calculations based on NBC monetary statistics.

(In percent of GDP)

Figure 6. Cambodia: Private Sector Credit by Institution (2021)

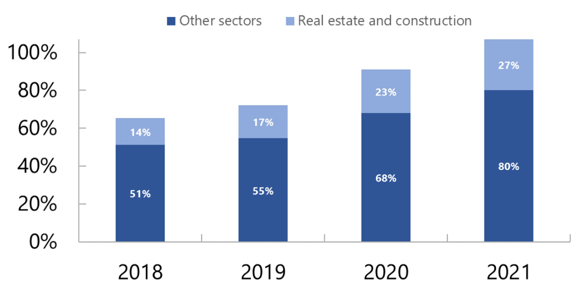
(In percent of Total)



Source: IMF staff calculations based on NBC monetary statistics.

4. Real estate and construction accounts for a quarter of corporate debt, but the largest share is accounted for by retail and wholesale trade. As of 2021, liabilities of the real estate and construction sector stood at 27 percent of Cambodia's GDP, less than a third of total outstanding corporate debt. However, trade (retail and wholesale) has historically been the largest recipient of credit across all business sectors; ratios of credit to GDP in retail have also experience the fastest growth during the pandemic. Currently, trade is estimate to account for 8 percent of GDP, but liabilities in this sector stand at 38 percent of GDP. As retail and wholesale sector tend to be import-intensive activities (and construction also heavily depends on imports), it is possible that these credit developments contributed to the widening of the current account deficit..

Figure 7. Cambodia: Composition of Corporate Sector Credit

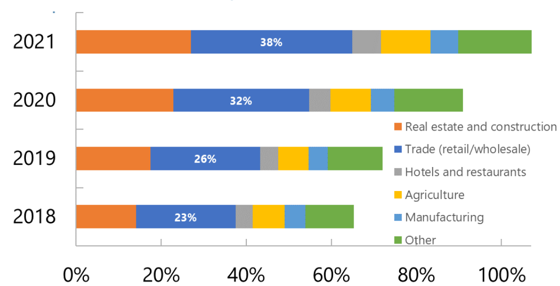


Source: IMF staff calculations based on NBC monetary statistics.

(In percent of GDP)

Figure 8. Cambodia: Corporate Sector Credit

(In percent of GDP)



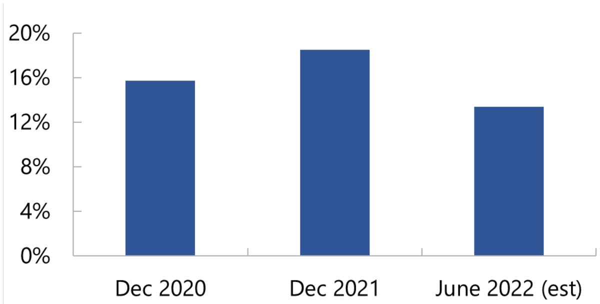
Source: IMF staff calculations based on NBC monetary statistics.

B. Assessing Risks from Private Sector Debt

5. Based on the limited information available, credit performance appears to be deteriorating. The overall volume of loans restructured one or more times reached US$ 3.8 billion, or 7 percent of total outstanding credit and 13 percent of GDP, by June2022.[2] The ratio of restructured loans to total outstanding remained overall stable between 2020 and 2021 and decreased in 2022; however, these ratios need to be read in light of sustained annualized credit growth, which keeps these ratios low.. As a share of GDP, the ratio of restructured loans in 2022 remains significant. Furthermore, official figures indicate that the volume of loans classified as non-performing corresponds to about 2.8 percent of outstanding loan volume as of June 2022, up from about 2 percent at the end of 2021. NPLs in June 2022 currently stand at 4.4 percent of projected 2022 GDP. These figures are based on self-reporting data from banks and exclude MFIs and MDIs—as well as extensive lending conducted by the shadow banking sector, such as real estate developers.

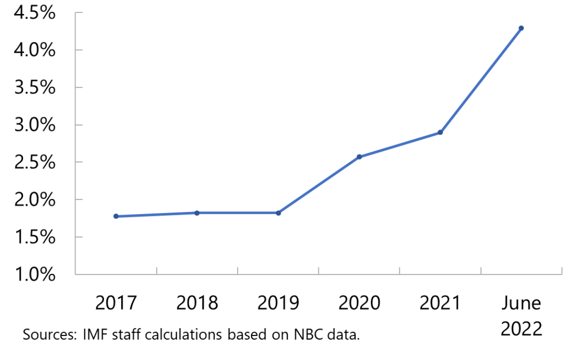
[2] Overall figures for loan restructurings are available for 2020 and 2021, but not earlier, thus impeding a comparison with the pre-pandemic phase.

Figure 9. Cambodia: Stock of Restructured Loans
(In percent of GDP)



Source: IMF staff calculations based on NBC data.

Figure 10. Cambodia: Non-Performing Loans
(In percent of GDP)



Sources: IMF staff calculations based on NBC data.

6. Many indicators point to a significant buildup of risk in the domestic financial sector. Credit developments in Cambodia are of some concern. Large outstanding amounts are accompanied by rapid and sustained credit growth, somewhat detached from economic fundamentals. While household leverage is also a concerning trend, most debt pertains to the corporate sector. Corporate debt is not heavily concentrated in real estate and construction, and household debt does not depend only on residential mortgages. Instead, most productive sectors in the economy appear to be heavily indebted, suggesting that a wave of insolvencies could materialize from a variety of different external and domestic shocks. Outstanding quantities raise concerns about debt overhang should a downturn materialize, especially given that insolvency regimes and banking resolution mechanisms are currently limited in scope.

7. Policy options in the event of adverse financial events are likely to be limited. Monetary policy is constrained by dollarization and by the peg—and a large amount of macroprudential stimulus, deployed during the pandemic, is yet to be rolled back. Choosing the appropriate timing for stimulus withdrawal is crucial, as untimely tightening may exacerbate liquidity problems in the banking sector. A wave of insolvencies could pose significant financial stability risks and translate into large contingent liabilities for the government.

8. The recent recovery is an opportunity to update and test legislation on bank resolution mechanisms and insolvency regimes. It would also be appropriate to improve the collection of statistics on borrowers' income and collateral, both for new originations and for outstanding loans. This information would enable the financial regulator to introduce prudential policy measures-such as DTI or LTV caps, aimed at curbing excessive credit growth going forward.

References

National Bank of Cambodia (2021), Financial Stability Review

DISTRIBUTIONAL IMPLICATIONS OF RISING ENERGY PRICES[1]

The increase in prices of fuel and other commodities disproportionally affects vulnerable Cambodians, eroding their real incomes. Using survey data from the 2019/2020 Cambodia Socio-Economic Survey, this annex simulates the effects of rising energy prices on income poverty. It also provides an estimate of the potential fiscal costs associated with shielding vulnerable households from rising prices via cash transfers.

A. Recent Price Trends

1. **Energy prices in Cambodia have been steadily increasing since mid-2021.** Beginning in the second quarter of 2021, the imported fuel price inflation has increased to as much as 40 percent (yoy), as recovering demand in emerging and advanced economies has increased price pressures on international energy markets. Price growth has continued throughout the first half of 2022 as the war in Ukraine has added pressures on oil, gas and coal prices. As a result, utilities inflation has risen above 10 percent (yoy) in the first quarter of 2022, mainly driven by price increases in solid and liquid fuels. Electricity prices have remained stable overall, owing to tariff regulation . Owing to the spike food and energy prices, headline inflation reached 7.8 percent (yoy) in June 2022, a significant deviation from the historical average.

Figure 1. Cambodia: Inflation by Selected Product Groups

(In percent yoy)

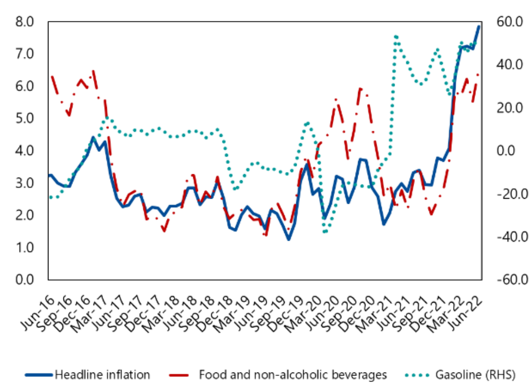
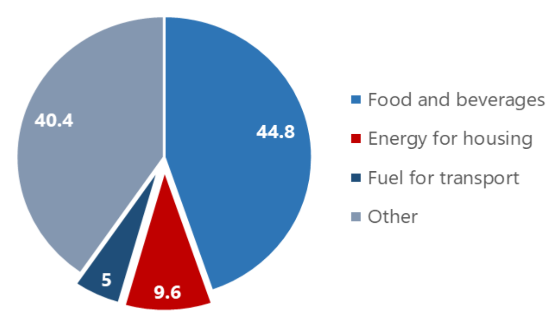


Figure 2. Cambodia: Consumer Price Inflation: Weights

(Percent)



2. **Soaring energy prices pose a significant threat to real household incomes in Cambodia.** Combined, spending on energy for housing and transportation accounts for 14.6 percent of the CPI basket. As wages and profits growth in 2022 are unlikely to keep up with current inflation rates, the erosion in real incomes owing to rising prices could be substantial.

[1] This note was prepared by Alessia De Stefani.

B. Methodology

3. To understand the distributional implications of inflationary pressures, this note employs a simple micro-simulation exercise using household-level survey data. The 2019/2020 wave of the Cambodia Socio-Economic Survey contains information on self-reported income for a sample of about 10,000 households that are meant to be representative of the general population. Each worker provides information about income from all sources (employment, self-employment, sale of agricultural goods, etc.); information about household composition allows to aggregate all earnings to compute total annual household income.

4. The simulation assumes a negative shock to total annual household incomes. It does so by applying a reduction coefficient which is directly proportional to expected inflation rates under each scenario. The coefficient is determined by the expected real income erosion that could arise due to different inflationary outcomes for 2022. For example, for a scenario in which annualized inflation is 5 percent in 2022, new household income is assumed to be 95 percent of income reported in the survey. If inflation is 6.6 percent, new income would be 93.4 percent of previous income, and so on as inflation increases under each scenario The simulation thus assumes no wage adjustment to inflation and no government intervention to compensate real income losses. It also assumes that all households consume the same set of goods, represented by shares in the CPI basket. As a result of real income erosion, the number of vulnerable households (defined as those living at or below the international income poverty line) increases, as more households are progressively pushed below the poverty line[2].

C. Poverty and Fiscal Costs Under Four Energy Prices Scenarios

5. Under the baseline inflation forecast for 2022 (prices rising 6.4 percent in 2022), the share of households living below the international poverty line would increase from 16 to 16.7 percent. The baseline forecast assumes energy prices rising 20 percent on average over 2022, underpinning an overall inflation rate of about 6.4 percent.[3] Assuming no adjustment in wages or profits and no government intervention to compensate households, the erosion of real income would push an additional 26,000 households below the 2022 international income poverty line (2.15 USD PPP per person/day).[4] The share of households living in poverty would increase by 0.7 percentage points compared to pre-pandemic levels.

[2] This approach draws upon the methodology used in De Stefani, Laws and Sollaci (2022) to evaluate the effects of the Covid-19 pandemic on income poverty.

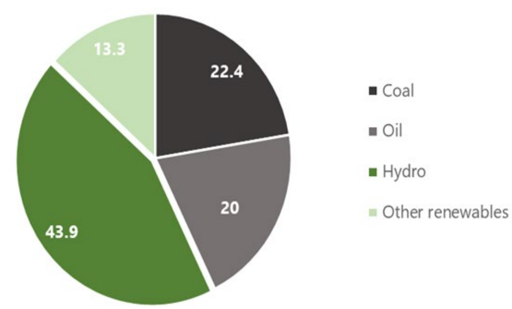
[3] Food is the largest component of the CPI basket: food prices are assumed to grow by 5 percent (period average) in 2022, driven by the rising prices of vegetables, fish and meat. Further food price pressure in late 2022 could result from rising rice prices, as increasing costs on fertilizers begin affecting domestic production costs.

[4] The 2022 threshold for low-income countries defines anyone living below 2.15 USD per/person day as living below the international income poverty line (Filmer et.al., 2022). The simulation obtains daily income values by dividing total household income by the number of household members.

6. The baseline inflation forecast assumes only a mild increase in energy prices. Under this scenario, the price of liquid and solid fuels rise significantly, but electricity price growth remains contained to 5 percent, as tariffs are capped. The 5 percent increase in electricity prices owes to increasing production costs due to rising costs of coal and oil, which account for 44.4 percent of domestic electricity production. However, hydro-power generation, the largest input by share, is expected to remain anchored to 2021 price levels, owing to multi-year purchasing agreements.

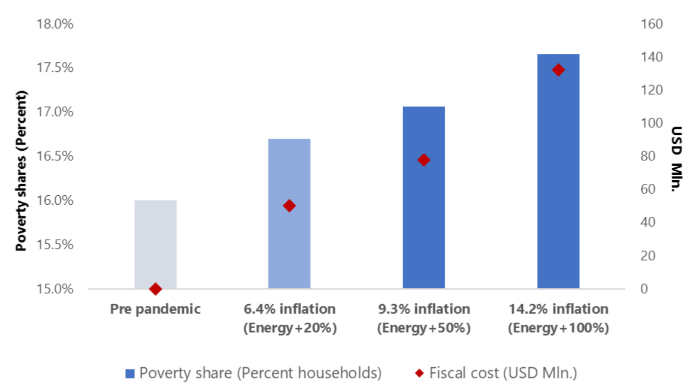
Figure 3. Cambodia: Electricity Generation by Source

(Percent)



7. A back-of-the-envelope calculation suggests that compensating all vulnerable households from the real income loss resulting from 5 percent inflation would cost around US$ 50 million. Currently, cash transfers budgeted for 2022 are around US$ 280 million (or 4.4 percent of expected non-grant revenues).

Figure 4. Cambodia: Poverty Shares and Fiscal Costs under Three Energy Price Scenarios



8. A more pessimistic scenario, with inflation reaching 9.3percent, would see poverty shares rising above 17 percent and generate fiscal costs of US$ 80 million. [5] Underpinning this scenario is a 50 percent increase in energy prices. This scenario is conservative, in that it only considers the direct implications of energy costs on households' consumption baskets and does not include potential indirect effects that rising energy costs would likely have on other categories of goods. Food price inflation, for example, would remain anchored around 5 percent.

9. Under more severe assumptions, such as energy prices doubling compared to 2021, inflation could reach 14 percent and income poverty could affect 18 percent of all households. The associated fiscal costs could rise to about US$ 130 million per year, corresponding to about 2 percent of projected fiscal revenues for 2022.

[5] Costs increase more than proportionally compared to the baseline scenario. This is due to three reasons: the number of vulnerable households increases; the inflationary shock is larger, hence compensating this households becomes more expensive; finally, as ex-ante richer households fall into poverty poorer, compensating them becomes proportionally more expensive.

References

De Stefani, A., Laws, A., Sollaci, A. (2022), Household Vulnerability to Income Shocks in Emerging and Developing Asia: The Case of Cambodia, Nepal and Vietnam, IMF Working Paper No. 2022/064 Filmer, D., Fu H., Sanchez-Paramo, C. (2022): An adjustment to global poverty lines, World Bank Voices

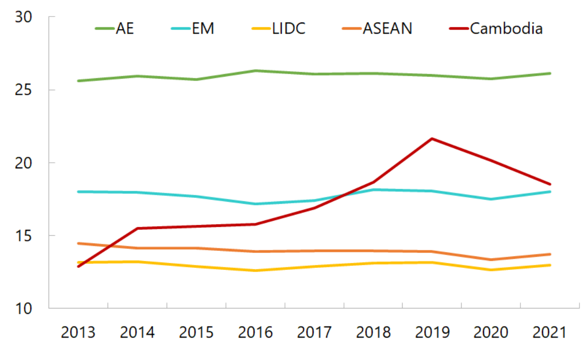
REVENUE MOBILIZATION[1]

The authorities have done commendable efforts to mobilize revenues over the past years. Nonetheless, additional public spending to support development needs and an expected decline in grants call for continued efforts. Based on past TA advice, we propose three potential areas to enhance revenue mobilization: excises, property taxes, and tax incentives.

1. **Over the past decade, the tax-to-GDP ratio in Cambodia has averaged 17 percent, near the average for emerging market countries.** Tax revenue as a share of GDP in Cambodia rose from around 13 percent in 2013—the average tax-to-GDP ratio in low income developing countries—to almost 22 percent in 2019. Since the Covid-19 shock, the tax-to-GDP ratio has fallen, reaching 18.5 percent in 2021. All in all, tax-to-GDP in Cambodia averaged 17 percent over the 2013-2021 period, near the EM average ratio of 17.8 percent.

Figure 1. Cambodia: Tax Revenue

(In percent of GDP)



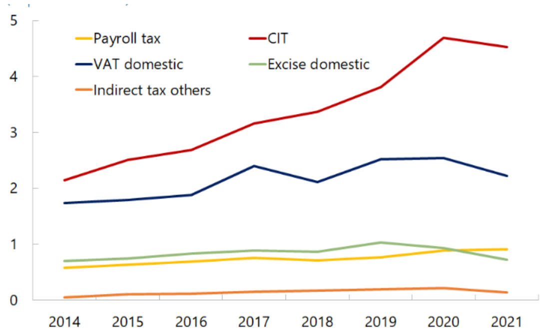
Sources: IMF World Economic Outlook Database
Note: ASEAN includes Singapore, Thailand, Philippines and Indonesia

2. **The rise in revenues-to GDP was supported by the authorities' robust administrative reforms and policies.** Since 2014, clear efforts were made to mobilize domestic revenues as laid out in the government's medium-term revenue mobilization strategies of 2014-2018 (RMS I) and 2019-2023 (RMS II). In particular, corporate income taxes (CIT) rose by 2.5 percentage points of GDP from 2013 to 2020. In 2016, Cambodia increased excise tax rates on items such as tobacco, automobiles, and petroleum products (in line with the recommendations of the March 2016 IMF tax policy technical assistance mission), as excise taxes were considerably lower than in comparator countries. Excise on imports increased by 2 percentage points of GDP by 2019 compared to 2016. Further, in 2017-2018, the authorities updated real-estate valuations for tax purposes which helped boost property tax revenues by about 1 percentage point of GDP (captured by the higher province tax revenues).

[1] Prepared by Juliana Araujo.

Figure 2. Cambodia: Income Tax, Domestic VAT and Excises

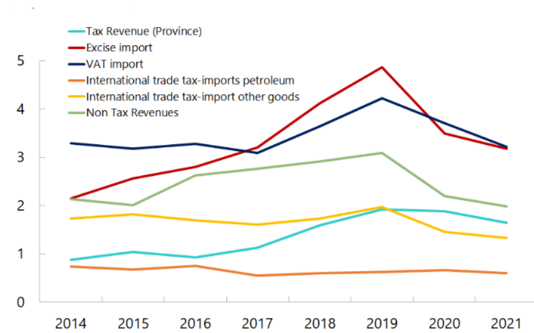
(In percent of GDP)



Sources: Cambodia authorities

Figure 3. Cambodia: Import Duties, Local Tax and Non-Tax Revenues

(In percent of GDP)



Sources: Cambodia authorities

3. **Despite improvements in revenue mobilization, a few factors point to the need of further efforts.** First, Cambodia aims at becoming an upper middle-income country by 2030 (and an advanced economy by 2050). A higher revenue:GDP ratio would be needed to finance the higher public spending (such as on health, education, and infrastructure) typically associated with middle income countries. Second, substantial revisions to GDP are expected as part of the GDP rebasing scheduled to take place in March 2023 translating into significantly lower tax-to-GDP ratios. Third, as Cambodia graduates from low-income country, grant revenue will keep declining and will need to be replaced.

4. **Technical assistance advice [from 2017] remain broadly relevant, proposing three potential areas to enhance revenue mobilization: excises, property taxes, and tax incentives**. The advice pointed to three potential areas to improve revenue collection that are yet to be explored: (i) excises; (ii) property taxes and (iii) tax incentives. This would be in line with the current RMS II which aims at targeting current revenue growth at 0.3 percentage of GDP per year while improving efficiency of the current tax policies (e.g. rationalization and modernization of tax administration). The recommendation is also in line with the objectives of the on-going Tax System Reform Study which include the assessment of existing tax policies and incentives for proposing changes where needed and omitting ineffective tax policies and incentives.

A. Excises

5. **Correcting for negative externalities generally points to use of specific taxes, while ad valorem excise taxes on vehicles could play a redistributive role.** In Cambodia, all excise taxes at present are on ad valorem basis, and are not determined by calculation of market externalities. Tobacco and petroleum taxes are a clear case for transition to specific excises, which directly address underlying externalities (health implications and pollution). An additional benefit of specific petroleum taxes is that they would reduce fluctuations in retail prices and revenues. While externalities can be addressed by specific fuel excises, ad valorem excises on vehicles (and luxury goods in general) complement existing consumption taxes by increasing the overall progressivity of indirect taxes. The Public Lighting Tax is particularly distortionary, because of cascading and

earmarking of its revenues. Moreover, it is not needed to address externalities, as it is raised on goods which are already subject to excises. Specific taxes are also easier to administer and provide greater incentives for quality improvements.

6. **The overall revenue consequences of modernizing excise taxes via a shift to specific taxes computed (in part) based on externalities should be estimated to inform policy decisions.** In the short-term, authorities should be mindful about striking a balance between using excise taxes as an instrument to correct for externalities (i.e., restoring efficiency) and as a tool for raising revenue. Smuggling (and possibly illicit production) can increase as a result of higher excise taxes. Thus, a strong tax administration is crucial for achieving the objective of the excise tax policy. The authorities are currently contemplating a move from ad valorem to a mixed system for certain products to match the government's objective of maximizing revenue collection and addressing fairness while also mitigating negative externalities. While excise taxes for petroleum in Cambodia could be considered as a mixed system, the specific component constitute only a small fraction of the overall excise tax.

Box 1. Recommendations on Excises

Tobacco. Replace ad valorem by specific tobacco excises, which should be regularly updated in line with inflation. Choose a specific excise of slightly higher value than the current average excise and consider further increases after assessing the implications for compliance. Over the medium term, raise the tax further toward the estimated costs of the negative health externalities.

Petroleum Products. Replace ad valorem by specific fuel excises. Choose a fixed amount that is slightly higher than the average over the year implied by the current ad valorem rate. Over the medium term, raise the tax further toward the estimated costs of the negative environmental externality.

Alcoholic Beverages. Specific taxes are also recommended for alcoholic beverages such as beer, but in the case of wine and spirits an argument can be made in favor of a mixed system

Vehicles. Maintain an ad valorem rate for motor vehicles.

Public Lighting Tax. Phase out the PLT. Replace local government revenues by higher property taxes (see Section III) and transfers if needed. Do not earmark the replacement revenues, but let local governments choose how best to use them. Raise alcohol excises to maintain on average the same (or a higher) final price to consumers.

B. Property Taxes

7. **Strengthening recurrent property tax should be a precondition for abolishing the unused land tax and reducing the property transfer tax.** The unused land tax raises minimal revenue and is costly to administer. Strengthening the recurrent property tax, in particular land

valuation and rates, would also help address property speculation. The property transfer tax raises significant revenue, but is distortionary: such taxes reduce the number of transactions and labor mobility, and may lead to collusive under declaration of sales values, which are needed for administration of the recurrent property tax. The basic exemption of KHR100 million excludes a large share of the population, reducing the administrative burden and enhancing progressivity. However, as the property tax is a local benefit tax, there is no justification for exempting government and SEZ properties.

8. **Administrative measures will be essential to fully realize revenue potential.** Raising rates without strengthening other components, such as the tax base, coverage, valuation, and collection, would increase inequities, reduce transparency and discourage compliance. A phasing period to allow administrative improvements could be considered. Administrative improvements should include measures for: (1) property registration; (2) property valuation in a dynamic property market; (3) enforcement of tax collection, and finally (4) revenue estimation capability. The broad tax base, including both land and buildings is common and appropriate. Currently, property market values for tax purposes are assessed and updated every five years in line with the mandate of the National Assembly but no indexing in the interim periods is in place. The last assessment of property values was conducted in 2019/2020. Recent efforts have been made to increase the property tax register through better access to property information from the Ministry of Land Management, Urban Planning and Construction.

Box 2. Recommendations on Property Taxes

Valuation of property. Provide in law or regulation a requirement for valuations to be reassessed at least every five years, with indexing in the interim years. Provide to the local valuation sub-commissions clear guidelines for valuation.

Exemptions. Repeal exemption for government properties over the medium term. Repeal exemption for property in SEZs over the medium to long term.

Recurrent property tax. In the short term: start raising the tax rate from its current level of 0.1 percent to strengthen revenue. In the medium term: continue raising the rate to 0.5 percent in tandem with administrative progress. In the long term: provide local governments the option to set local rates within a modest range set by the central government.

Unused land tax. Repeal the tax on unused land over the medium term.

Property transfer tax. Reduce the property transfer tax rate over the medium term (but only to the extent that its revenue can be at least replaced by increased revenue from the recurrent property tax).

Property tax administration. (i) Establish an independent dispute resolution process for the property tax. (ii) As improved administrative capabilities allow, gradually expand the geographical coverage of the property tax to the whole of the country over the medium to long term. (iii) Seek technical assistance to formulate a detailed multi-year roadmap for administrative reform, specifically aimed at improving: property registration for tax purposes; property valuation to better track market developments; tax enforcement; revenue estimation and simulation capabilities.

C. Tax Incentives

9. Foreign investors face higher effective tax rates than domestic investors under the standard tax system due to the combination of the CIT and withholding on dividends. The corporate income tax rate is low, and various tax incentives are offered. However, a relatively high withholding tax rate on dividends of 14 percent (10 percent in some future double taxation treaties) raises the effective tax rate and creates profit-shifting incentives. As a result, foreign investors face higher effective tax rates than domestic investors under the standard tax system, despite a likely more elastic investment demand.

10. The corporate income tax holiday, which is just a deferral of tax until distribution, should be abolished. If the deferred tax is paid, the tax saving is a timing advantage only. If, however, the deferred tax is avoided, then the usual disadvantages of tax holidays apply, such as being particularly attractive to relatively short-lived or footloose investment and encouraging rent-seeking behavior and corruption. Exemptions from customs duties and VAT remain important, but better solutions are available. VAT would not present a problem for exporters if VAT credits were reliable and timely. Finally, reducing or abolishing customs duties on intermediate or capital goods would be preferable to exemptions for selected taxpayers. The exemption from the minimum tax is less relevant now. The minimum tax does not apply anymore to companies that maintain strong accounting records—which is likely the case for most international investors. As reflected in the new Law on Investment promulgated in September 2021, which retain CIT exemptions, the authorities continue to view CIT as one of the key attractions for investors but recognize that there is room to minimize/rationalize the tax incentives.

11. Tax incentives should be costed and published regularly (i.e., a tax expenditure budget). All tax incentives should be moved into the Law on Taxation and the responsibility for approving and monitoring all tax incentives should be assigned to MEF. This recommendation aim at improving transparency and allowing a coherent design of tax policy.

12. VAT refunds should be timely. Under the Revenue Mobilization Strategy (RMS) 2019-2023, the government has improved VAT refund processing through the adoption of the e-VAT refund system, internal crosscheck of invoices between GDT and GDCE, and the use of the Key Performance Indicator in the RMS to reduce the time of VAT refund on an annual basis. All VAT refund requests remain subject to a review process that includes the verification of VAT invoices. Only a small share of VAT refund requests are processed within 30 calendar days.

Box 3. Recommendations on Tax Incentives

Corporate income tax holidays. Abolish corporate income tax holidays for new investments, but grandfather those of QIPs that have already been authorized (including those in the "trigger" period before the tax holiday).

Repatriated dividends withholdings. Reduce the withholding tax rate on repatriated dividends to 10 percent. Consider further reduction in medium term.

Box 3. Recommendations on Tax Incentives (concluded)

Corporate income tax. Maintain the statutory CIT rate at 20 percent. There may be pressure for further reductions in the future, but there is no need for pre-emptive cuts.

Publish regular estimates of the costs of tax incentives (i.e., a tax expenditure budget). Move all tax incentives into the Law on Taxation. Assign the responsibility for approving and monitoring all tax incentives to the MEF.

VAT refunds. Ensure timely VAT refunds, so that VAT indeed is a tax on domestic consumption.

MACROPRUDENTIAL POLICIES[1]

In Cambodia, the regulatory framework has not yet assigned a mandate for macroprudential policy to any institution. Furthermore, the macroprudential toolkit remains limited, with some of the available instruments not yet fully operational. A simple index to measure the macroprudential policy stance suggests that most measures have historically been loose, except for minimum reserve requirements in FX. Macroprudential polies remain loose, with all measures currently set below the neutral policies, except for the Liquidity Coverage Ratio (LCR).

1. **The legal and regulatory framework has not assigned a mandate for macroprudential policy to any institutions.** Nonetheless, the National Bank of Cambodia (NBC) established a Financial Stability Committee in 2011, chaired by the Deputy Governor, to monitor and assess financial stability, macroeconomic, and banking risks. Given the banking system is dominant, covering more than 80 percent of the financial sector in terms of assets, and the instruments are already available to the central bank, macroprudential policy is *implicitly* mandated to the central bank. A National Financial Stability Committee (NFSC) was established by the NBC, the Ministry of Economic and Finance, and Securities and Exchange Commission of Cambodia in August 2019. The NFSC is chaired by Prime Ministers to issue policies and crisis management measures to maintain financial stability.

2. **The macroprudential toolkit is still limited**. As of June 2022, the toolkit includes the capital conservation buffer (CCB), limits on foreign currency lending, the minimum liquidity coverage ratio (LCR), limits on net open foreign exchange positions, and minimum reserve requirements (RR) in FX and local currency. The enabling regulation for the counter-cyclical capital buffer (CCyB) has not been issued.

3. **Furthermore, some of the existing instruments are used for other purposes rather than for preserving financial stability and mitigating systemic risk.** For instance, reserve requirements are the main monetary policy tool. Since 2020, minimum reserve requirements have been the same in foreign and domestic currency, despite differences in liquidity risks (from a macroprudential standpoint, a differentiated calibration is typically warranted). A cap on FX lending was set at 90 percent in 2019 to help promote de-dollarization. All in all, the use and calibration of instruments according to other objectives curb the effectiveness of the macroprudential policies.

4. **Other potentially relevant instruments for Cambodia could be considered.** In particular, limits on the leverage ratio, stable funding requirements, household sector leverage limits (e.g. loan-to-value (LTV) and debt-service-to-income (DSTI) limits), and corporate sector instruments (e.g. caps on corporate credit by sector, sectoral risk weights) are lacking. The authorities have recently used the CCB as a shock absorber, for lack of a better instrument, delaying the full implementation of the

[1] Prepared by Juliana Araujo.

CCB at the beginning of the pandemic (by keeping it at 1.25 percent instead of adopting the 2.5 percent 2020 regulatory target).

5. **A simple macroprudential policy index suggests that the macroprudential policy** (MPP) **stance has been loose for most of the past decade.** This note proposes a simple index (denoted as I_{MPP}) to measure the macroprudential policy stance in Cambodia. For each macroprudential policy i, a neutral policy MPP_i^* is defined. A total of four policies MPP_i are included as part of the index. A neutral LCR is assumed to be the Basel III recommended ratio of 100 percent, and a neutral CCB to be the Basel III recommended 2.5 percent of total risk-weighted assets (RWA). The neutral reserve requirements in local currency and FX are set as 8 and 12 percent, respectively, which corresponds to the median minimum reserve requirement during 2000-2020 for each currency. Other measures are not included due to limitations in defining a neutral policy. The macroprudential policy index I_{MPP} is defined as:

$$I_{MPP} = \sum_{i=1}^{n} \frac{I_i}{n}, \qquad where\ I_i = \frac{MPP_i}{MPP_i^*}$$

The macroprudential stance is currently loose, with all measures currently set below the neutral policies, except for the LCR (text figure). In addition, no bank has made use of the allowance with respect to the CCB, as they have used the forbearance on loan classifications extensively, suggesting there has been an abundance of support with respect to need. In the past decade, most measures have been loose, except for reserve requirements in FX, which were tightened for a brief period prior to the global financial crisis (and moderately tightened prior to the Covid-19 shock).

Figure 1. Cambodia: Macroprudential Policy Stance

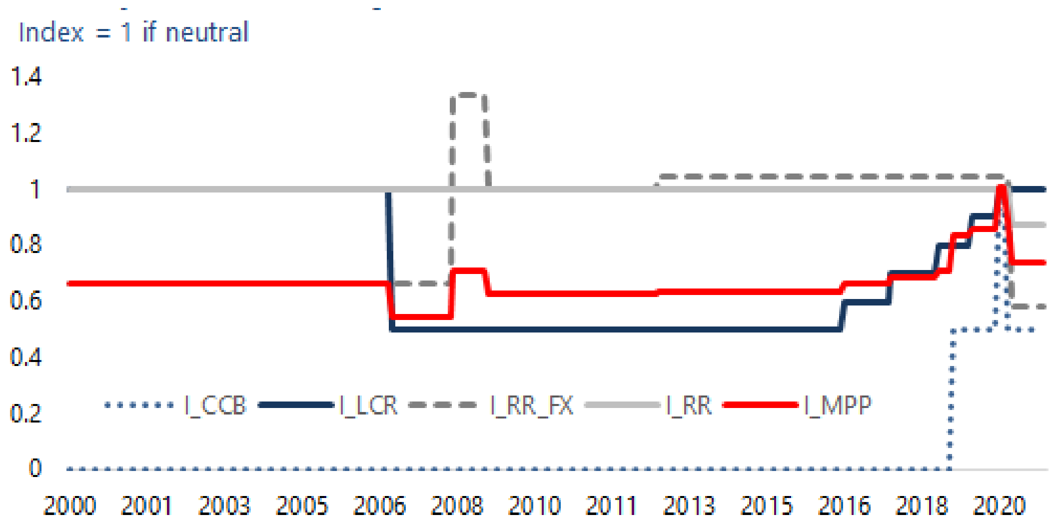


Table 1. Cambodia: Macroprudential Toolkit		
Tool		**Description**
Countercyclical capital buffer	✓	The NBC may set the CCyB in the range of 0 percent to 2.5 percent of total RWAs, which will be specified in a separate instructional circular. Currently, the CCyB is 0 percent because the regulations on how to calibrate are missing.
Capital conservation buffer	✓	The CCB is set to 2.5 percent of total RWAs. A prakas in February 2018 requires commercial banks to add at least 50 percent of the buffer effective January 1, 2019, and fully implement effective January 1, 2020. Note that effective March 2020, because of Covid-19, the NBC has reversed the implementation of the CCB ratio by requiring banks to hold 50 percent of the buffer (the same as 2019) and wait to see the Covid-19 situation before reimplementing the full measure.
Other capital requirements	☒	
Limits on leverage ratio	☒	
Loan-loss provisioning	☒	
Limits on credit growth	☒	
Other loan restrictions		
Exposure caps to particular industries or sectors	☒	A cap on bank lending to the real estate sector, at 15 percent of bank loan portfolios, was set in June 2008 but removed in January 2009.
Limits on Foreign Currency Lending	✓	From December 2019, the NBC has required 10 percent of loans to be in riel.
Limits to loan-to-value ratios	☒	
Limits to debt-service-to-income ratio or loan-to-income ratio	☒	
Tax	☒	

Table 1. Cambodia: Macroprudential Toolkit (continued)

Tool		Description
Limits to the loan-to-deposit ratio	☒	
Liquidity Coverage Ratio	✓	As announced December 23, 2015, and effective September 1, 2016, deposit-taking corporations (including foreign branches) and microfinance institutions are required to meet the LCR requirement. The LCR sets minimum LCR requirements for deposit-taking banks and financial institutions. It aims at: promoting short-term resilience of As announced December 23, 2015, and effective September 1, 2016, deposit-taking corporations (including foreign branches) and microfinance institutions are required to meet the LCR requirement. The LCR sets minimum LCR requirements for deposit-taking banks and financial institutions. It aims at: promoting short-term resilience of each institution's liquidity risk profile. Ensuring that each institution has an adequate stock of unencumbered liquid assets that can be converted to cash at no or little loss of value in markets, to meet its liquidity needs for a 30-day liquidity stress scenario. Ensuring that prompt corrective actions are taken by the institution's management when the LCR potentially falls below the minimum requirement. The LCR has two components: LCR=Market value of the stock of eligible liquid assets/Total net cash outflows within 30 days≥100%. The LCR is being phased-in according to the following scheme: Effective September 1, 2016, an LCR of 60% was implemented. Effective September 1, 2017, the LCR increased to 70% from 60%. Effective September 1, 2018, the LCR increased to 80% from 70%. Effective June 1, 2019, the LCR increased to 90% from 80%. Effective January 1, 2020, the LCR will be increased to 100% from 90%.
Stable funding requirements	☒	
Limits on net foreign exchange positions	✓	As announced August 27, 2007, and effective the date, banks and financial institutions must at all times maintain their net open position in foreign currencies in either any foreign currency or overall net open position in all foreign currencies, whether long or short, may not exceed 20% of banks' and financial institutions' net worth. The Prakas has the purpose of preventing banks' and financial institutions' foreign exchange risks.

Table 1. Cambodia: Macroprudential Toolkit (concluded)

Tool		Description
Reserve requirements for macroprudential purposes		
Aggregate	✓	Effective December 1993, deposit-taking corporations (including foreign branches), banks, and microfinance institutions are subject to the reserve requirement regulation. The objective of this measure is to mitigate liquidity risk and credit risk. Required reserves are calculated based on demand deposits, time deposits, foreign currency deposits, government deposits, and savings deposits. Assets that are allowed to be held as required reserves include the following: (1) bank reserves denominated in domestic currency; (2) bank reserves denominated in foreign currency; (3) reserve assets. Different reserve requirement rates are imposed across types of deposits, currencies, banks, and others. The levels of reserve requirement applied to domestic currency liabilities and foreign currency (US$) liabilities were 8% and 12.5%, respectively, as of 2016. Only the difference of 4.5% of reserves in foreign currency liabilities is remunerated, and the reserve requirement ratio is only applied to the outstanding stock of reserves.
Differentiated by currency	✓	Reserve requirement rates are differentiated between local and foreign currency. The levels of reserve requirement applied to local currency liabilities and foreign currency (US$) liabilities were 8% and 12.5%, respectively, as of 2016. Only the difference of 4.5% of reserves in foreign currency liabilities is remunerated, and the reserve requirement ratio is only applied to the outstanding stock of reserves. As noted, because of Covid-19, effective March 17, 2020, and April 1, 2020, the NBC temporarily reduced reserve requirement rate on KHR and foreign currency to 7% (from 8% and 12.5%) until further notice. Effective October 1, 2020, reserve requirement rate on foreign currency and KHR will remain at 7% until further notice.
Systemically important financial institutions	☒	The NBC can require an increase in the solvency ratio up to 30% to institutions or groups that could represent significant threat to the depositors and to the financial system as a whole.