STRUCTURAL POLICY COUNTRY NOTES

Cambodia

Cambodia

A. Medium- term economic outlook (forecast, 2013-17 average):

GDP growth (percentage change):	6.9
Current account balance (% of GDP):	-8.3
Fiscal balance (% of GDP):	-2.7

B. Medium-term plan

Period: 2009-13

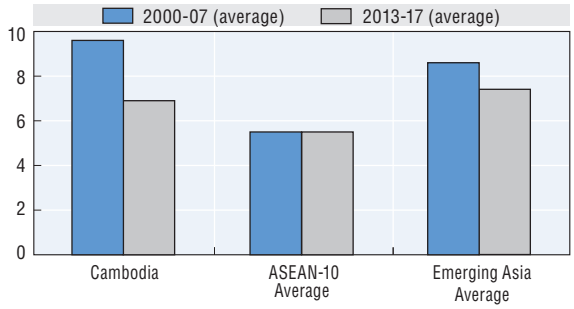
Theme: For growth, employment, equity and efficiency

C. Basic data (in 2011)

Total population:	15 million*
Population of Phnom Penh:	1.3 million (in 2008)
GDP per capita at PPP:	2 216 (current USD)

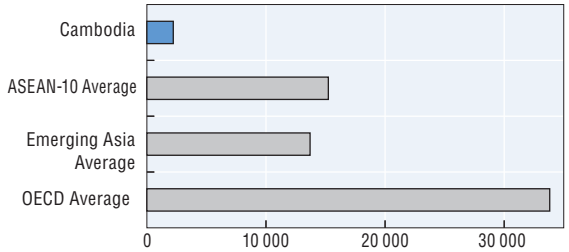
Note: *Total population data for 2011 is an estimate.
Sources: OECD Development Centre, MPF-2013, national sources and IMF.

GDP growth rates (percentage change)



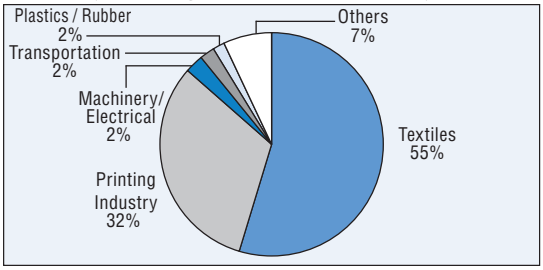
Source: OECD Development Centre, MPF-2013.

GDP per capita, 2011 (PPP, current USD)

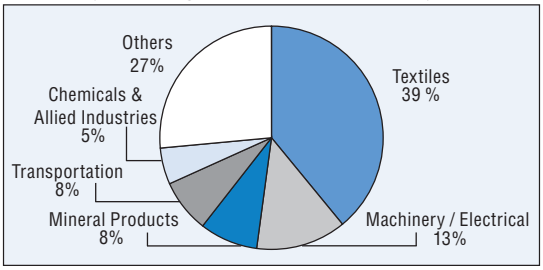


Source: IMF and national sources.

Composition of exports in 2011
(percentage share of total exports)



Composition of imports in 2011
(percentage share of total imports)



Source: Trademap.

The government of Cambodia has transformed the country from a post-conflict to a market-oriented economy characterised by steady economic development. Peace and political stability were eventually re-established in 1991 with the signature of the Paris Peace Agreements. Two years later came the 1993 Constitution, which laid the foundations for liberal democratic development and a market economy. Economic performance has indeed been impressive and the government has made headway in its work to strengthen governance (which lies at the heart of its Rectangular Strategy for growth, employment, equity and efficiency). Its efforts include the Anti-Corruption Law which was passed in 2010. In 1999, Cambodia joined ASEAN then, five years later, the World Trade Organization (WTO) in 2004. Its membership of the two organisations has allowed Cambodia to reap the benefits of regional co-operation and international trade.

The country faces a number of challenges. It must further upgrade infrastructure to bring agriculture into the commercial mainstream. Milled rice exports could be an engine of growth and help reduce poverty, but not until the export procedure has been streamlined and the milling process is made more efficient. Productivity is a weakness in agriculture and most other sectors. Human resource development could help, but Cambodia's educational and TVET system need to be reformed. Enrolment rates at all levels are quite low. The result is a mismatch between economic needs and a large unskilled labour force. The banking sector offers a relatively brighter outlook. Its capital base is sound and growth has been brisk, with microfinance business burgeoning. Cambodia's central bank must build its capacity and modernise its infrastructure if it is to play a part in economic growth and operate effective supervisory processes that ensure customer protection and the stability of the sector.

Cambodia's medium-term policy challenges and responses

- Build agricultural productivity and tap the export potential
- Increase enrolment rates at all levels of education and strengthen TVET to build a skilled labour force
- Strengthen the banking sector and prudential measures

POLICY FOCUS

Build agricultural productivity and tap the export potential

The critical importance of agriculture and agricultural reform

Agriculture is of critical importance to the Cambodian economy. It employs more than half of the country's total labour force and is the chief source of income for the rural poor, who account for the poorest 10% of the population. Cambodia has adopted a three-pronged strategy to develop its agriculture: productivity enhancement, diversification and transition from subsistence to commercial agricultural. To that end, it is implementing a package of inter-related measures. They involve building and upgrading institutions and infrastructure (roads, irrigation, power, ICT); instituting land reform; encouraging farmers' organisations; providing agricultural extension services and inputs; modernising the financial sector.

Milled rice production and exports offer Cambodia great growth potential

Rice is the dominant crop and, for low-income Cambodia, a strategic commodity in policies to foster income growth, poverty reduction and food security. It is pivotal to the first pillar – agricultural development – of the country's Rectangular Strategy, whose second phase the government has firmly committed to implementing. Cambodia nurses the ambition of becoming a major international exporter of rice, or "white gold". In this respect, paddy rice offers great export potential and could make a strong, valuable contribution to growth. Production has bounced back in remarkable fashion over the past decade since the Asian financial crisis and could reach 7.3 million tonnes in 2010-11, borne by the impetus of rising global and regional food demand and prices.

The global milled rice trade grew from 29.7 million tonnes in 2009 to an estimated 31.3 million in 2010, even though prices continued to fluctuate as a result of the changing economic and political landscape. Furthermore, because paddy rice is politically sensitive

and central to national religions and food security in many countries across the world, they protect and heavily subsidise their markets. In Asia, it is estimated that the milled rice trade may reach 14.5 million tonnes in 2010, while prices, though fluctuating, should follow an underlying upward trend. The Asian demand for imports of medium- and low-quality milled rice has been on the rise, owing to the combined effects of unfavourable weather conditions in the Philippines, crop failures and reduced fertiliser subsidies in Indonesia, and the requirement by some countries in the region to fill their reserve stock. Overall, however, the regional and global milled rice trade offers Cambodia high growth potential in the medium and long term.

A successful rice policy could drive growth if support framework is in place

In order to capitalise on the global and regional market potential and translate into reality its vision of becoming a world "rice basket" and a major world milled rice exporter, Cambodia has launched a "policy for paddy rice production and the promotion of milled rice exports". Should it prove successful, it will act as a catalyst for the promotion of Cambodia's exports in general. The policy comes on top of other already-adopted policy measures designed to pick low-hanging fruit in 2010 and 2011. It will also pave the way for medium- and long-term measures to ensure sustainable growth in milled rice production and exports and constitute a common policy framework to guide future implementation.

Medium-term measures

- Increase paddy rice productivity by using high yield seed and modern farming techniques.
- Continue to expand irrigation.
- Continue to build and maintain rural roads to connect rice production areas to markets.
- Promote micro lending to farmers.

Long-term measures

- Enhance water management, key to crop productivity and intensification of yield.
- Implement the National Policy on Rural Electrification.
- Promote and establish farmers' organisations (the Rice Millers' Association) to strengthen their capacity to secure and make efficient use of loans from financial institutions and acknowledge their contribution to the economy.
- Promote and encourage the implementation of policy to ensure the sustainable use of agricultural land and ensure security of tenure.
- Encourage participation of the private sector in paddy rice processing and milled rice export.
- Ensure paddy rice millers' and exporters' access to government-guaranteed loans, recapitalise the Rural Development Bank and Agriculture Development and Support Fund, create new financial instruments and leverage mechanisms, and put in place the Agriculture Development Bank.
- Reduce electricity prices in line with fairness and efficiency and extend coverage to rural areas through the rigorous enforcement of existing laws and regulations.

In general, developments in the global milled rice market, together with Cambodia's sound economic growth, have created an overarching environment conducive to the supply chain and milled rice export. Nonetheless, Cambodia still faces a number of key challenges and obstacles to the supply chain, particularly in agricultural land management, farming techniques, the lack of infrastructure, financing arrangements, and institutional capacity.

Rice exports inhibited by inadequate processing methods and weak infrastructure

One key challenge is productivity. If Cambodia is to export between 3 and 4 million tonnes of milled rice every year, it needs to produce at least 10 or 11 million to ensure a sufficient export surplus. That surplus is still limited, which raises issues of productivity such as land management, research and extension services, intensification and farmers' organisations. The government's over-riding priorities, however, are to expand the irrigation system and rural road infrastructure, invest in modern farming techniques and ensure security of land tenure.

Cambodian rice farmers receive 35-40% less for their produce than their Thai and Vietnamese counterparts. Although such low prices may be perceived as an important factor in export competitiveness, any gains are offset by informal fees and high transport and processing costs by the time the milled rice reaches the ports. The snag is that exporting unprocessed rice results in a significant loss of value added for the economy. If Cambodia could mill all its paddy rice, it would generate substantial gains by taking broken grains, husks, and bran and spinning them off into other activities such as cooking oil production, aquaculture and animal husbandry – not to mention benefits such as job creation and income generation.

With additional investment in modern rice milling facilities, Cambodia could produce more high-quality milled rice for growing international markets. To that end, however, it must address two critical cost-related impediments – the high cost of energy and transport; and the high cost of and difficult access to credit.

Another big obstacle to the promotion of Cambodian milled rice exports is export facilitation, which is neither smooth nor consistent. That is as true of hard export infrastructure such as transportation, seaports and warehouses as it is of soft trade enabling mechanisms such as support institutions, quality standards, or sanitation and phyto-sanitation standards (SPS), etc. The crucial issues in this respect are weak institutional support, rice whose quality is not yet recognised internationally and a limited seaport infrastructure.

To compound matters, milled rice is a protected market with complicated mechanisms shaped by the terms and requirements specific to each importing country. At the same time, milled rice export is a new venture for Cambodia. Its experience and knowledge are limited and it will require time and resources to strengthen its ability to access international markets.

POLICY FOCUS

Increase enrolment rates at all levels of education and strengthen TVET to build a skilled labour force

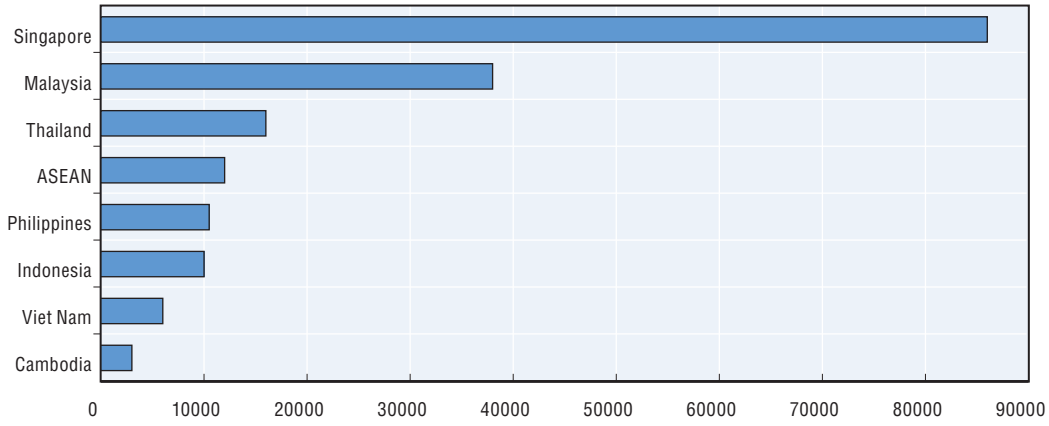
Expanding but unskilled labour force

Cambodia's demography has been largely shaped by its history over the last four decades. The civil war and Khmer Rouge regime left millions dead, but the fall of the regime in the early 1980s and the lasting peace which took shape in the 1990s were marked by baby booms. The result today is a so-called "youth bulge" in Cambodia's population, which has led to an expanding workforce and a shortage of skilled labour due to the country's inefficient education system.

Nevertheless, labour productivity has increased in almost all industries over the last decade, although overall employee output level is lower than in other ASEAN countries (Figure 2.1.1). The growth in labour productivity – value added per person employed – was most impressive in mining and quarrying, with an annual growth of 19.4%. Next came finance and other services, then transport and communications, while productivity dropped in the electricity, gas and water sectors.

If Cambodia is to compete with other countries in the region, especially in the aftermath of the global economic crisis, it will have to further improve its labour productivity.

Figure 2.1.1. **Output per worker in Cambodia and other Southeast Asian countries, 2008**
(constant 2009 USD)



Source: National Institute of Statistics. 2010. Ministry of Planning Cambodia. *Labour and Social Trends in Cambodia* 2010, ILO. p.31.

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Poor enrolment rates and returns on education

Cambodia's overall education enrolment rates are the lowest in ASEAN. Although it does quite well in primary education, it brings up the rear in secondary and tertiary education. Its secondary level gross enrolment ratios may be only four points behind Lao PDR's, but they are 57 points behind Brunei's and 43 behind those of the Philippines and Thailand, which rank first, second and third. At tertiary level Cambodia's performance is even worse (Table 2.1.1).

Table 2.1.1. **Gross primary, secondary and tertiary enrolment ratios in Cambodia and other Southeast Asian countries**

	Primary		Secondary		Tertiary	
Country	**2000**	**2007**	**2000**	**2007**	**2000**	**2007**
Cambodia	102	119	18	40	2	5
Indonesia	109	117	55	73	14	17
Philippines	112	109	77	83	30	28
Malaysia	97	98	65	69	26	30
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Myanmar	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Brunei	111	106	85	97	13	15
Thailand	106	104	67	83	35	48
Lao PDR	109	118	35	44	3	12
Viet Nam	106	n.a.	65	n.a.	9	n.a.

Source: UNESCO Institute for Statistics.

One of the most important aspects of a good education system is that it forms skilled workers who, when they embark on their careers, yield returns on their education both themselves and for the economy as a whole. One major problem with education and TVET in Cambodia is that they do not seem to yield high returns in employment and career advancement. The country's listed unemployment rate is actually quite low: in 2007 the Supreme National Economic Council reported a rate of 0.9% according to its strict definition of "unemployed and actively looking for work", and 3.82% under the looser wording "unemployed and available for work but not actively looking". However, those figures may be low because, given the lack of unemployment support schemes, many people are forced to find some kind of work rather than earn no income at all. However, the quality and pay levels of such jobs are poor, even for qualified workers.

What is important is that low returns on education limit the incentive to attain anything higher than the most basic levels of education. The nature of the Cambodian economy does not help matters: a high proportion of the labour force works in informal economic activities, either in a self-employed capacity or as unpaid family workers (Table 2.1.2).

Table 2.1.2. **Employment status of the population 10 years and older in Cambodia, 2004 and 2007**
(percentage)

	2004			2007		
	Total	**Male**	**Female**	**Total**	**Male**	**Female**
Employee	20.0	23.3	16.6	23.3	26.9	19.5
Employer	0.1	0.1	0.1	0.1	0.1	0.03
Own account worker	34.4	39.7	28.8	35.8	43.1	28.2
Unpaid family Worker	43.3	34.8	52.0	40.7	29.8	52.3

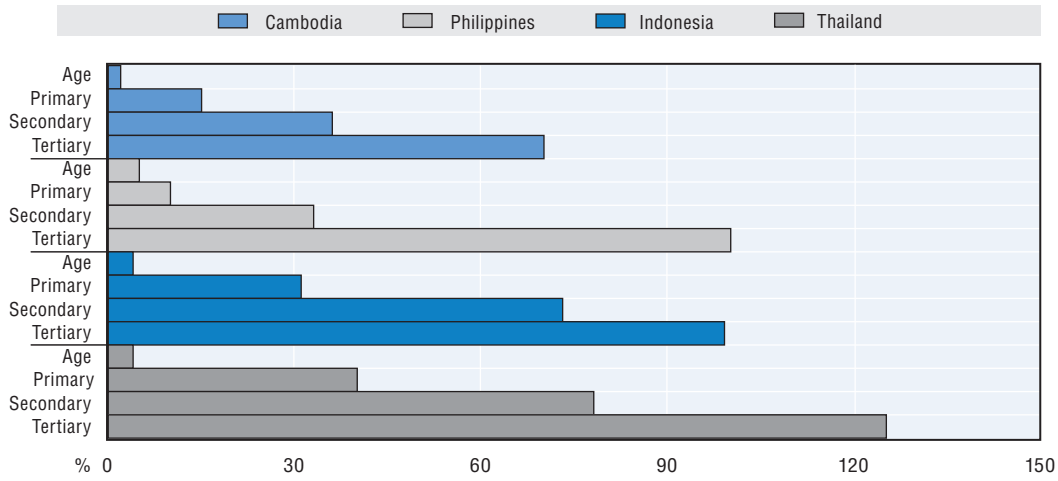
Source: Supreme National Economic Council (2009), Labour Market and Youth Employment, Supreme National Economic Council under auspices of UNDP/IFA, p. 12.

Formal sector employment, though growing, remains small, with paid employees accounting for only 23.3% of the overall workforce. However, wages do not rise with levels of schooling. Although the average income in Cambodia is relatively low, the

rise in monthly pay levels for several more years of schooling is too slight to act as an incentive for staying on in education. In 2007, the average wage for someone who had completed primary school was USD 58.14 per month, while a worker who had reached lower secondary level earned USD 61.35 – only USD 3.21 per month more for three extra years in education. Comparison between the wages of workers who have attained lower secondary and upper secondary levels reveals an even slimmer pay differential: USD 62.17, or USD 0.82 more for an extra three years of schooling. While workers who hold vocational/technical qualifications and university degrees do earn considerably more, there is powerful disincentive for staying on at school to secondary level.

The returns on education are in fact lower in Cambodia than in many other parts of ASEAN. In its returns on primary education, it performs similarly to the Philippines, but worse than Indonesia and Thailand. It is significant that in the other three countries, most pupils continue on to higher levels of education, which suggests that returns are expected to be lower. In Cambodia, however, a large portion of the population will not stay on. Returns on secondary education are again similar to those of the Philippines, but behind Indonesia and Thailand. In tertiary education, the picture is even grimmer (Figure 2.1.2).

Figure 2.1.2. **Returns to age and education in Cambodia and other Southeast Asian countries, 2004**



Source: World Bank, 2010. *Providing Skills for Equity and Growth: Preparing Cambodia's Youth for the Labor Market.* Human Development Department East Asia Pacific Region. p. 45.

StatLink *http://dx.doi.org/10.1787/888932774053*

Higher education suffers from low enrolment and institutional disarray

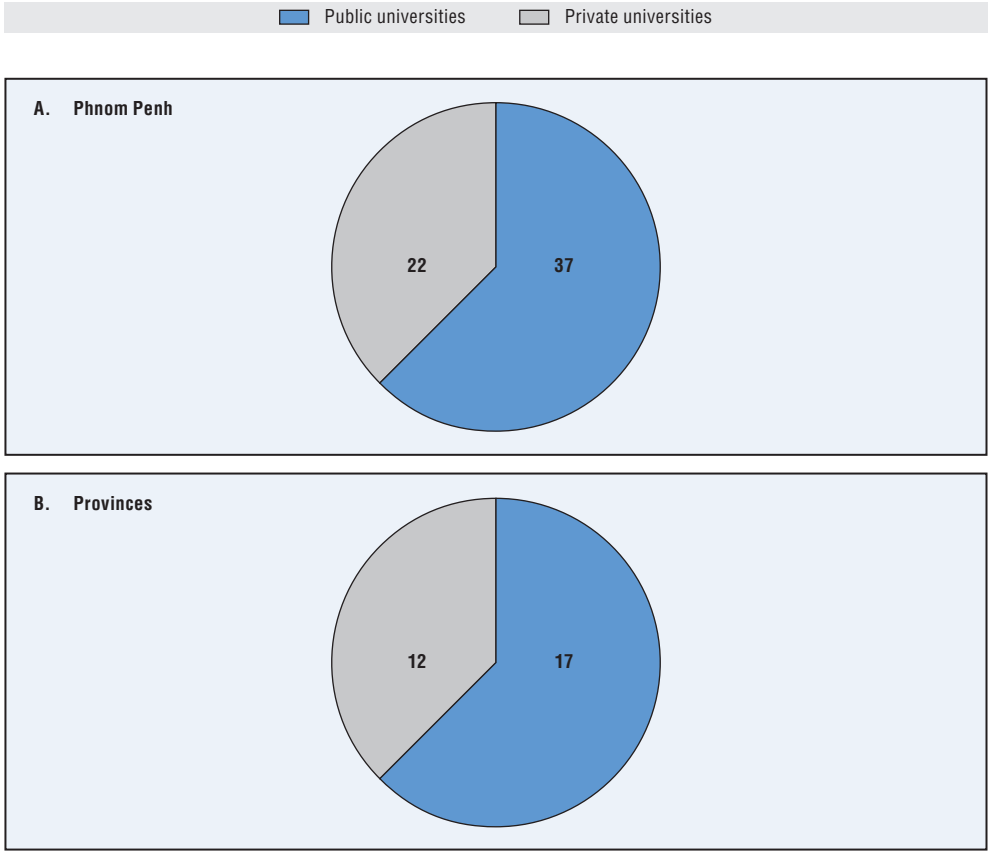
The state of the higher education system in Cambodia, which consists of university degree courses and TVET qualifications, is characterised by very disparate organisational mechanisms, weak quality output and low enrolment. These three factors greatly inhibit the development of higher education and grooming more capable human capital in the country should be a major focus for reforms.

A university degree course in Cambodia usually spans four to seven years, depending on the course and the establishment. Most students begin at the age of 18, although there are also a number of mature students of varying ages. A total of 11 ministries and

agencies provide higher education services and thus have access to public education budgets. Two of the biggest ministries are the Ministry of Education, Youth and Sport (MOEYS) and the Ministry of Labour and Vocational Training (MOLVT). While Cambodia's Education Law states that the MOEYS is responsible for general, higher and vocational education, it provides no explanation for the role of the MOLVT. The result is mismanagement and competition between the two ministries, which clearly makes co-ordination of the higher education system very difficult for the government – an issue examined in greater detail later.

A further challenge to higher education comes in the shape of urban-rural disparities. The vast majority of universities are in Phnom Penh, although there is a growing number of higher education institutions, mainly private, in the provinces (Figure 2.1.3).

Figure 2.1.3. **Number of universities in Cambodia, by location**



Source: Ministry of Education, Youth and Sport.

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Table 2.1.3 shows that both university education and TVET face the same problem of low enrolment levels. While the numbers of students at tertiary level have grown over the last five years, they remain extremely low for a population of over 14 million and must be increased if reform of the TVET and university systems is facing any measurable effects.

Table 2.1.3. **Numbers of students enrolled in higher education and TVET in Cambodia**

Level	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Bachelor degree (4 years)	1 041	1 126	1 158	1 408	1 330	1 981
Associate degree (2 years)	1 237	2 201	2 172	3 151	2 959	3 308
Vocational Training Certificate 1, 2 and 3 (from grade 10-12)	594	503	1 562	1 524	1 214	746
Vocational Training Certificate (less than 1 year/non-formal)	10 692	17 722	64 970	67 178	117 240	66 695
Training at private institutes and NGOs	14 330	26 434	18 505	40 387	45 887	47 447

Source: Ministry of Labor and Vocational Training, Cambodia.

Cambodia's education system's inefficiency to build human capital threatens its development

The challenges of Cambodia's education system are of two kinds: demand side and supply side. On the demand side is an unwillingness or inability to attend school, while on the supply side lies the inefficiency of the Cambodian government and education system to deliver quality educational resources.

These challenges are daunting road blocks to attaining higher levels of education. Cambodia must address both the supply and demand sides of its inefficient education systems it is to grow its stock of skilled human capital.

Other ASEAN countries seem to be more successful in realising an employment market which rewards individuals for attaining higher levels of education. Cambodia is failing to do so, which will turn even more students away from continuing their further education in the future. The skills level and productivity of the workforce will suffer, which will, in turn, affect the country's economic growth.

POLICY FOCUS

Strengthen the banking sector and prudential measures

Strong year-on-year growth in bank assets and retail services

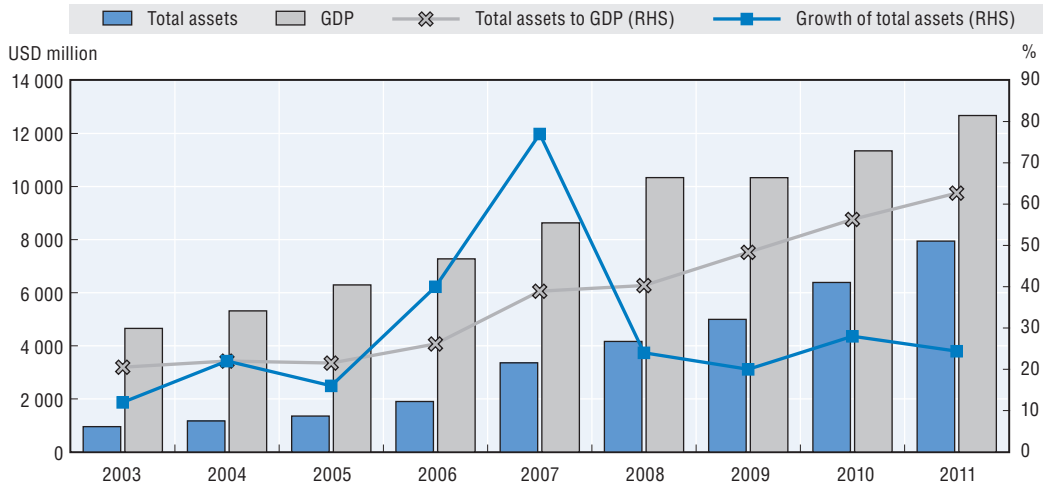
The Public Financial Management Reform Programme (PFMRP) is one of the key elements of Cambodia's Rectangular Strategy for growth. The long-term vision of the PFMRP is to build an international standard for its public financial management system through a strategic plan that comprises four stages: (1) building budget credibility, (2) improved financial accountability, (3) improved budget-policy linkages, and (4) improved performance accountability.

Banking sector reform in particular lies at the heart of PFMRP. The sector grew significantly in 2011, with total assets increasing by 24.39% and credit by 33% (or USD 1 085 million) over the previous year. The growth in credit was the result of a 20% or USD 880 million rise in deposits and a 9.85% or USD 112 million expansion in the capital

base. The ratio of total assets to gross domestic product (GDP) reached 63% in 2011 from 56% in 2010, while those of total loans and total deposits to GDP in 2011 also rose – from 28% in 2010 to 34% and from 37% to 41% respectively.

In terms of outreach, performance in the banking sector presented substantial progress. Though the number of borrowers increased slightly, the number of depositors jumped by 19% to 1 266 412 accounts by the end of 2011. The number of branch networks and banking service outlets climbed 7.1% in 2011 to number 421 country-wide. Other modern banking services such as automated teller machines (ATM), debit cards and credit cards also expanded rapidly. The number of ATMs rose to 588, while new credit cards issued in 2011 increased by 53% and debit cards by 29% against 2010. As of year-end 2011, the total number of money changers in Cambodia was 1 296, of whom 47 were licensed money changers and 1 249 registered counters.

Figure 2.1.4. **Growth in the ratio of total assets to GDP in Cambodia, 2003-11**



Source: National Bank of Cambodia Annual Report 2011.

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Microlenders gain business and help reduce poverty

Cambodia's microfinance sector continues to grow rapidly in size and numbers of operations. It provides financial services to SMEs as well as to people in the remote areas who have no access to financial services from commercial banks.

As of year-end 2011, there were 32 licensed microfinance institutions, of which seven were microfinance deposit takers. This development is reflected in the 47.97% increase in the whole sector's total assets from KHR 2 051 billion (Cambodian riel) (USD 506.16 million) at the end of 2010 to KHR 3 025 billion (USD 748.97 million) at the end of 2011.

Thanks to favourable business, regulatory and policy environments, the sector has won significant confidence from debtors and creditors alike, particularly from the poor in rural areas and foreign investors. As of 31 December 2011, Cambodian shareholders owned 23% of total registered capital, while foreigners held 77%. Total loans increased by 50% from KHR 1 725 billion (USD 426 million) at the end of 2010 to KHR 2 591 billion (USD 641.53 million) a year later, while the number of borrowers climbed 17% from

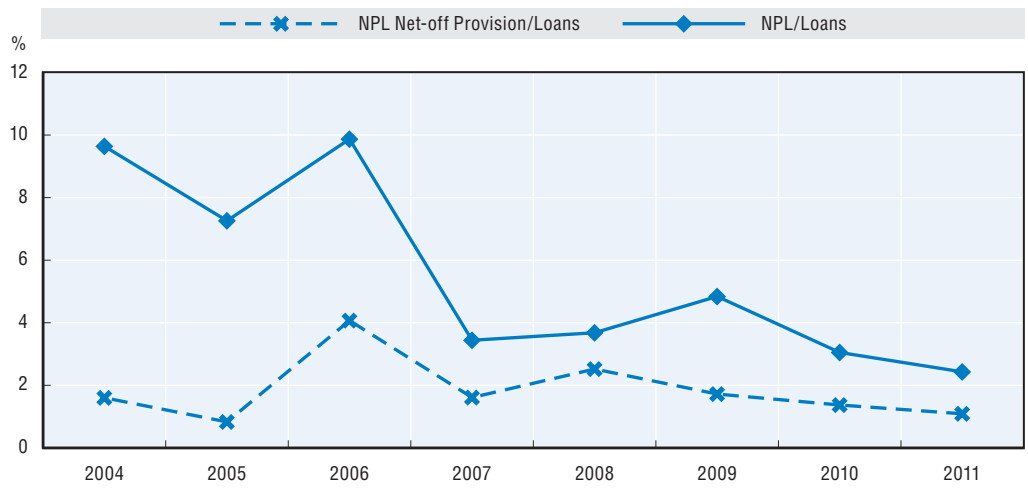
978 077 to 1 141 913. Over the same period, the aggregate amount of deposits surged 180% from KHR 164 billion (USD 41 million) to KHR 459 billion (USD 114 million).

The microfinance sector not only contributes to reducing poverty in rural areas through its micro lending services, but also affords job opportunities to many Cambodian graduates. As of December 2011 the total number of staff employed in the microfinance sector was 9 744, of whom 2 617 were women.

Banks have sound capital base, but the growth in credit calls for vigilance

The average delinquency rate in 2011 was 0.22%, falling from 1.18% in 2010 despite the severe flooding in the country in the third quarter. In compliance with the regulations of the National Bank of Cambodia, the average solvency ratio was 21.25 % and the liquidity ratio 398.66%. Microfinancing profitability continued to increase. In 2011, total net profit was KHR 110 117 million (USD 27.26 million), a 63% rise against the previous year. Returns on asset and equity ratios were 3.64% and 15.10% respectively.

Figure 2.1.5. **The ratio of non-performing loans to total loans in Cambodia, 2004-11**



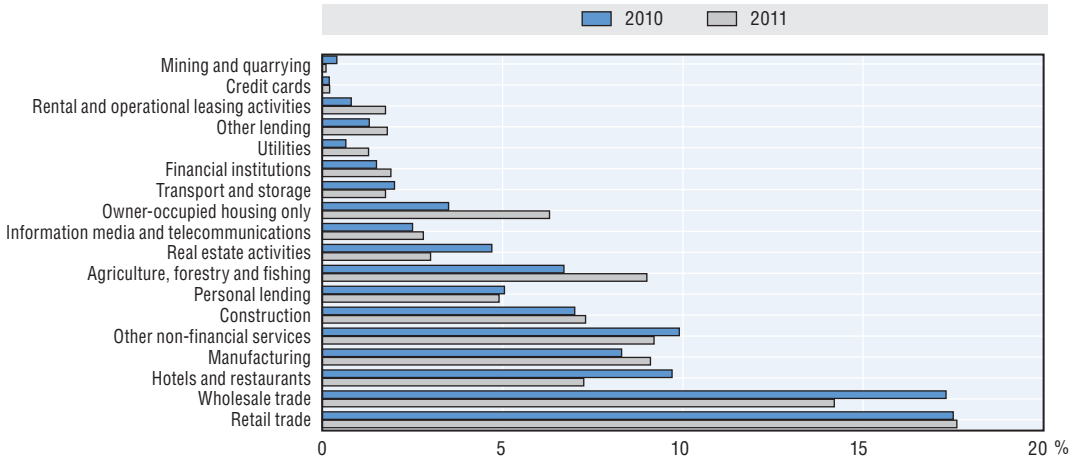
Source: National Bank of Cambodia Annual Report 2011.
StatLink http://dx.doi.org/10.1787/888932774110

Despite the relatively high growth in loans as of year-end 2011 (33.5%) and the flood disaster that affected agriculture, non-performing loans in the banking sector declined to 2.43% from 3.05% in 2010. Net nonperforming loans fell from 1.37% to only 1.09%, while total reserve provisioning remained stable at 55% of the non-performing assets.

Related-party lending is reported to be within the prudential limit of 10.7% of net worth. Total large exposures in proportion to net worth surged to 97% from 80% in 2010.

The retail and wholesale sectors captured one-third of the total portfolios, while manufacturing, non-financial services and agriculture each accounted for around 9%, and tourism and construction 7.4%. Though all indicators point to a satisfactory outlook in loan performance, vigilance should be exercised in closely monitoring credit growth, particularly in the real estate sector.

Figure 2.1.6. **Bank loans in Cambodia, by economic sector, 2010-11**
(percentage of total)



Source: National Bank of Cambodia Annual Report 2011.
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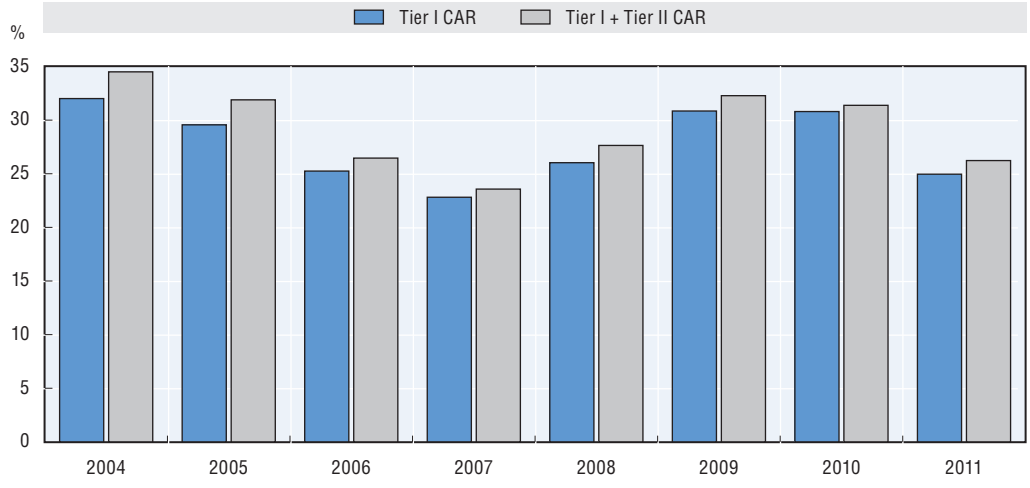
Bank liquid assets remained relatively stable while liquidity stress coverage for one-month periods increased. Off-balance sheet commitments doubled from the previous year.

The development of money and capital markets is expected to provide more room for liquidity management in banking institutions. Profitability in the banking sector showed significant improvement over the previous year. The average return on assets increased to 1.89% while the average return on equity was 9.02% by the end of 2011. The solvency ratio dropped from 31.38% by year-end 2010 to 26.23% by the end of 2011, but still remained above the prudential limit and the early-warning threshold. The fall was due mainly to rapid credit expansion and, by the same token, an increase in risk-weighted assets. Tier I capital was 24.96%, demonstrating to the regulator that banks had a strong stable capital base in 2011.

Figure 2.1.7. **Tier I CAR and Tier I + Tier II CAR in Cambodia, 2004-11**



Source: National Bank of Cambodia Annual Report 2011.
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Strengthen prudential measures as bank business grows and new products proliferate

To complement its regular off-site and on-site inspections, Cambodia's central bank is responding by gradually evolving its supervisory approach to one that is risk-based and forward-looking. It needs to accelerate the process and, to improve the information flow, update its supervisory reporting system for both banking and microfinance institutions. The central bank could switch to a reporting system that uses online submissions, which would be an effective way of providing timely, accurate information on the condition of banking and financial institutions. It would help ease the administrative burden and costs of banks and financial institutions submitting their reports. Such a move would also be a sign that Cambodia's banking sector is responding to rapid technological change and the fast-moving environment of the industry.

The central bank has indeed made a number of improvements. In 2011, the National Bank of Cambodia issued a circular related to net worth calculation and five other *prakas* (regulations): on risk-based and forward-looking supervision; credit information sharing systems; transparency in banks' and financial institutions' credit-granting; the financial leasing business; and the licensing of financial lease companies. However, the central bank needs to do more.

As banking sector growth continues to accelerate, new products and services develop. Examples are financial leasing and hire purchase arrangements for consumer purchases and the bank centric and mobile banking centric models now operating in Cambodia. The National Bank of Cambodia must regulate and supervise the mobile banking business – and sophisticated new products – in order to ensure the protection of consumers.

If the banking sector is to play a part in promoting economic growth, then it needs to improve its existing infrastructure, reform and upgrade its national payment system, and create a regulatory platform for an interbank market. The central bank has actually helped to create a privately owned credit bureau (which was launched in March 2012) to enhance the intermediary functions and risk management functions of regulated entities. It is designed to facilitate credit flows in the economy by reducing information asymmetries between banking institutions and their consumers.

Strengthening banks' accounting practices would be a major contribution to the sectors' domestic development and its regional integration. Cambodia banks are expected to implement the International Financial Reporting Standard (IFRS) by 2016 and are currently studying the IFRS road map ahead of full adoption. The road map sets out areas in which both banking authorities and market players can improve their current practices. It is hoped that they will lead to desirable changes in accounting policy, information systems, personnel and skills sets, and prudential regulations. Another crucial step towards ensuring sustainable development should be to improve co-operation among financial regulators within the country. As demonstrated by the global financial crisis of 2009, there is a need for closer co-ordination between onsite supervisors and offsite regulators in order to avoid regulatory arbitrage.

Cambodia has adopted a number of prudential measures to address the issue of operational risks in the areas of governance, fit and proper testing, and internal control. Its progress in risk management, particularly operational risk, has so far proved satisfactory. Nevertheless, additional prudential measures – especially capital charges for operational risk – should be taken in response to banking institutions' growing scope and scale of operations.

Box 2.1.1. **How prudential regulations affect financial stability and competition – OECD countries' experience**

The 2008-09 global financial crisis has thrown into relief the vital role of strong, well-designed prudential regulations in ensuring financial stability and put the issue at the centre of discussions and research in OECD countries. A study by Ahrend et al. (2009) explores how financial sector regulation affects stability and competition outcomes. Drawing on survey information collected by the World Bank, the authors build banking prudential regulation (BPR) indicators in eight thematic areas:

- capital requirements;
- liquidity and diversification requirements;
- accounting and provisioning requirements;
- external auditing and information disclosure requirements;
- entry rules and ownership structures;
- exit rules and disciplining devices;
- depositor protection;
- strength of the supervisory authority.

Their examination of the links between prudential regulation and the recent financial crisis shows that, in the period between 2007 and 2009, OECD countries with relatively tight prudential regulations in the areas of entry and ownership rules, exit and disciplining rules, and strength of supervisory authority suffered significantly smaller losses in bank share prices in the first quarter of 2009 relative to their pre-crisis values. The size of the coefficient estimated by Ahrend et al. suggests that improving regulation from the level of a moderately loosely regulated country – at the 25th percentile of the cross-country distribution – to that of one that is moderately tightly regulated – at the 75th percentile – would have been associated with a share value that was 19% higher at the beginning of 2009 than in 2007.

According to the findings of Ahrend et al. the net fiscal costs of the crisis would have been roughly 1.5% of GDP lower in a country with moderately strong prudential regulation (especially in the areas of capital requirements, accounting and provisioning requirements, and entry rules and ownership structures) than in one with moderately weak regulatory settings.

Although the empirical evidence suggests that the share prices of banks which were more strongly regulated in the pre-crisis period (i.e. between 2002 and 2007) rose less than loosely regulated ones, they also declined less during the crisis. The result was a net positive effect, due mainly to the positive effects of accounting and provisioning and entry and ownership requirements. The analysis by Ahrend *et al.* found that, ceteris paribus, a country with moderately strong average prudential regulation had about 30% more banking equity left in 2009, relative to its 2002 value, than a country with moderately weak pre-crisis regulatory settings.

OECD evidence also seems to suggest, moreover, that there is not necessarily a trade-off between stability and competition in the banking sector. Although in a few areas, such as entry rules and ownership structures, tighter prudential regulations appear to hamper competition, they do not in general affect it and, in areas like the strength of the supervisory authority, they even enhance it.

Source: Ahrend et al. (2009).

Another prudential challenge to which Cambodia's central bank should rise is minimising the possibility of regulatory arbitrage and, at the same time, assessing the need for introducing additional prudential regulations. The bank should review key regulations related to credit and liquidity risk and put in place regulations governing market and operational risk.

Capacity building should continue to be the National Bank of Cambodia's top priority and it has acknowledged that it needs sufficient human resources in place and the time necessary to build the right skills and expertise. Institutionalising the capacity building programme should be a priority in order to ensure qualified, high quality human resources.

Overall, vulnerabilities within the banking sector remain at manageable level despite some concerns on credit and liquidity risk. The banking sector's performance is "back on track" with all signs pointing to a positive outlook for the pace and depth of growth. The intermediary function is expanding rapidly, giving the financial system greater depth and outreach.

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