



FINANCIAL ACCESS AND STABILITY IN CAMBODIA: OPPORTUNITIES AND CHALLENGES

By Senh Senghor



Introduction

The financial sector plays an important role in promoting economic growth and inclusiveness. It facilitates savings and investments, fostering the efficient use of financial resources. Global experience shows that financial inclusion is important for growth and reducing inequality and poverty.

Amid impressive economic growth over the last decades, Cambodia's financial system has been rapidly changing, reinforcing old and creating new challenges to safeguarding financial stability. In recent years, the country has experienced a rapid expansion in domestic credit, which has grown at a rate of around 30 percent a year before slowing to 21 percent in 2013 due to political uncertainty surrounding the national election (NBC 2013). At the same time, the number of commercial banks has increased from 17 in 2003 to 44 in 2013 (NBC 2013).

The rapid growth of the financial sector has given rise to both optimism about the economic outlook and concerns about potential macroeconomic instability. Financial deepening, i.e., the increased provision, and widening choice, of financial services of which all levels of society can take advantage, is largely beneficial to economic growth as it generates more capital for business investment and production expansion. With growing opportunities, financial deepening is a "catching up" process for developing countries. However, it is feared that excessive credit growth, which might

be triggered by such financial deepening, can increase the likelihood of instability in the banking system. Data from the National Bank of Cambodia (NBC 2013) suggests that although bank lending is diversified in the aggregate, credit growth has accelerated particularly in riskier segments such as real estate and construction. At the same time, credit growth has also begun to outpace deposit growth.

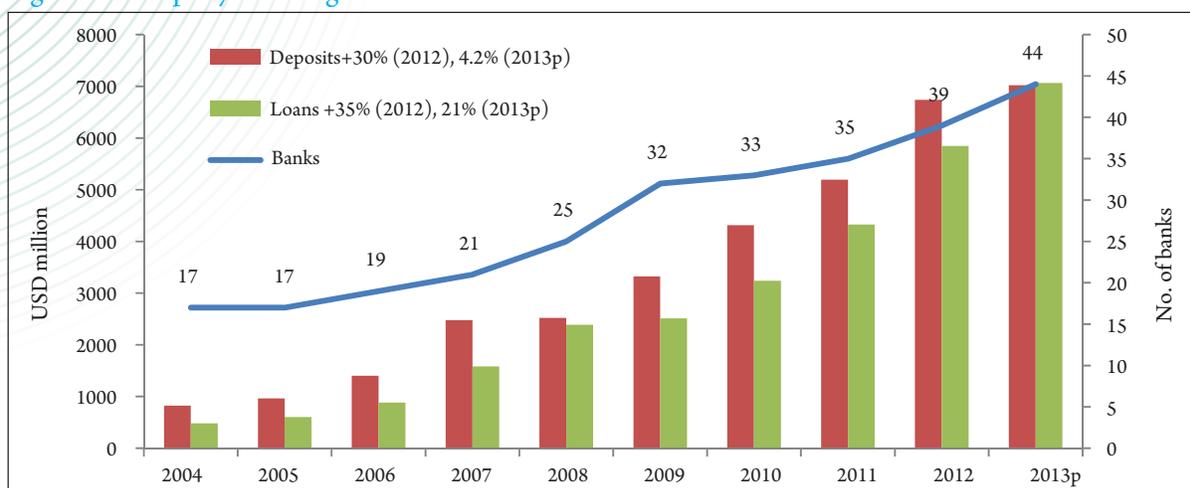
Against this background, what are the key challenges in building a deeper financial system to support Cambodia's development while safeguarding financial stability? And how should Cambodia address them?

In July 2012, the Royal Government of Cambodia officially launched the Financial Sector Development Strategy 2011-2020 – the roadmap for the development of the financial sector (RGC 2012). This roadmap aims to open access to financial services, improve financial literacy and increase financial inclusion, nurturing growth in key sectors of the economy such as agriculture while maintaining financial stability.

This report summarises the main points concerning financial sector development and economic growth discussed in a series of research workshops and policy roundtables held by the Cambodian Economic Association (CEA) in 2013 under the Development Research Forum (DRF) of Cambodia with funding support from the International Development Research Centre (IDRC) of Canada. It touches mainly on credit growth and financial stability, along with opportunities and challenges for agricultural financing. The rest of the report is structured as follows: section 2 presents an overview of Cambodia's financial sector, section 3 discusses

Senh Senghor, research manager, Cambodian Economic Association (CEA). Recommended full citation: Senh Senghor (2014), Financial Access and Stability in Cambodia: Opportunities and Challenges, Development Research Forum Synthesis Report, April 2014, No. 5, www.drfcambodia.net

Figure 1: A Rapidly Growing Financial Sector in Cambodia



Source: NBC 2009, 2010, 2011, 2012, 2013

credit growth and its implications for financial stability, while section 4 focuses on agricultural financing. Section 5 considers the way forward.

Characteristics of the Financial System in Cambodia¹

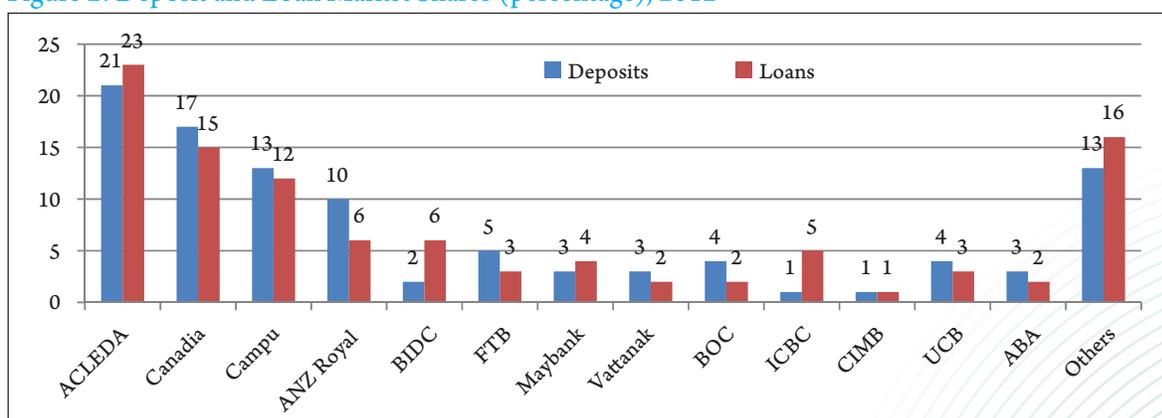
Cambodia, although still classified as a low-income country, has a financial sector with characteristics typical of a middle-income country. Despite its per capita GDP of USD1035, it has a high bank density and its credit-GDP ratio stood at 47 percent in 2013, which is the median level for a middle-income country. As Figure 1 shows, the

number of banks has increased from 17 in 2004 to 44 (35 commercial and 9 specialised) in 2013, and credit has grown at a rate of more than 30 percent annually between 2009-2012, slowing to 21 percent in 2013 due to political uncertainty.

Cambodia's financial sector is characterised by high dollarisation, high foreign ownership, high concentration and low penetration. More than 90 percent of the transactions in the banking system use US dollars, and two-thirds of the banks are foreign owned (IMF 2012). The big four banks (ACLEDA, Canadia, Campu and ANZ Royal) hold 61 percent of deposits and carry 56 percent of the loan market (Figure 2). However, only on a small percentage of the population (around 10 percent) hold formal loans and savings accounts. The lack of access to financial services continues to

¹ This section summarises the introductory parts from the DRF Policy Roundtables organised by CEA in August and November 2013, on "The Banking sector in Cambodia: Opportunities and Challenges", and "Financing Agriculture in Cambodia".

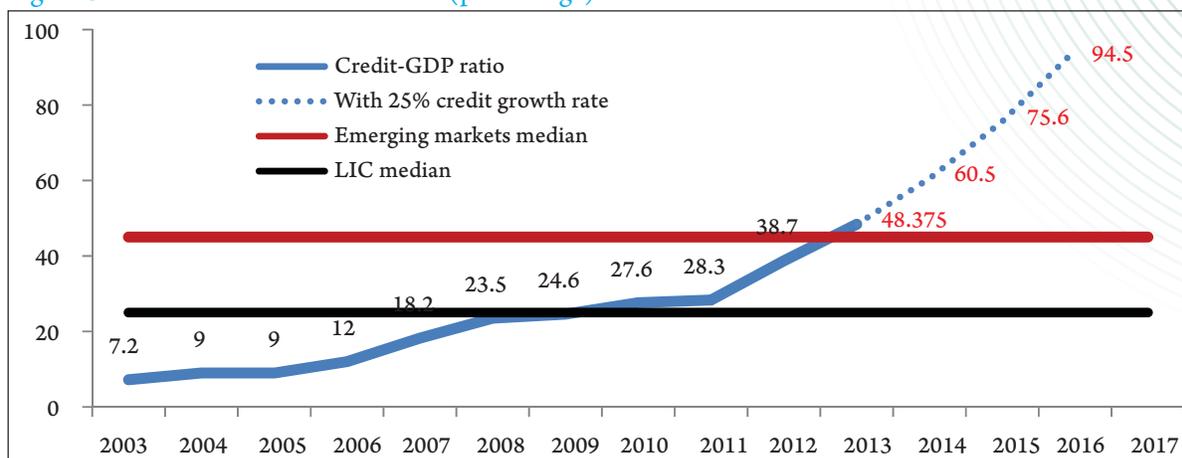
Figure 2: Deposit and Loan Market Shares (percentage), 2012



ABA=Advanced Bank of Asia, BIDC=Bank for Investment and Development of Cambodia, BOC= Bank of China, FTB=Foreign Trade Bank of Cambodia, ICBC=Industrial and Commercial Bank of China, UCB=Union Commercial Bank

Source: NBC 2012

Figure 3: Credit Growth in Cambodia (percentage)



Source: NBC 2013; IMF 2012

be a significant challenge to the general population and firms, although microfinance – the extension of very small loans to households and small-scale enterprises – has been expanding rapidly.

It is clear that banks face a number of challenges. First, there has been a shortage of qualified human resources and a lack of technical capacity, especially in risk management.² Second, the large number of banks can diminish the profitability of some banks and has led to the question of whether Cambodia is overbanked.

As mentioned in IMF (2012: 14), “An ‘overbanked’ financial system does not necessarily imply a competitive banking system”. The proliferation of banks might provide individuals with access to financial services but could become more challenging for financial regulators and supervisors. In that regard, the challenge for the banks and the associated public sector authorities would be to ensure a smooth and orderly consolidation process.

Credit Growth and its Implications for Financial Stability³

Strong credit growth in emerging market economies has often been attributed to the

catching-up process of economic development: more credit is needed for investment opportunities. However, cross-country experiences show that soaring credit growth can result in credit booms and thus pave the way for future busts (Leaven and Valencia 2012). Credit booms tend to feed excessive demand, inflationary pressures and speculative asset price bubbles (see, for example, Reinhart and Rogoff 2011). Excessively fast domestic credit growth then can have serious macroeconomic consequences, especially if it is accompanied by an unsustainable current account deficit.

In Cambodia, the strong credit growth that has been observed can be explained by two factors. First, it could stem from the normal catching-up process of a developing economy. With peace and political stability, the speed of financial sector development in Cambodia picked up between 1999 and 2007. Second, Cambodia’s financial sector has grown rapidly from a relatively small base.

In 2011, credit increased by 35 percent compared with a 30 percent increase in deposits (NBC 2011). Based on cross-country experiences, there are some concerns that credit growth seems to be excessive. Cambodia’s credit-to-GDP ratio is already well above the median for a low-income country having reached middle-income country level (Figure 3). Moreover, there has been concern about the use and destination of credit and the financial sector’s effectiveness in managing credit risks. Experience in many countries suggests that interactions between financial system elements

² In 2012 commercial banks and MFIs employed around 2600 staff, and the financial sector as a whole employed 4000 staff (NBC 2012).

³ This section draws on the presentations and discussion at a DRF policy roundtable organised by CEA in Phnom Penh on 7 August 2013. Speakers included Grant Knuckey, CEO of ANZ Royal, and Ahmed Faisal, Residential Representative of the IMF.

can amplify quickly beyond certain thresholds, thus creating systemic instabilities (see, for example, Claessens and Kose 2013). Concern about the banking sector is justified by the fact that Cambodia's financial system is dominated by large banks. Note that compared with other types of capital flows such as foreign direct investment (FDI) and portfolio inflows, bank flows are much more volatile.

Some argue that domestic credit growth does not pose significant risks yet as Cambodia's financial system has been expanding from a very small base. As In Channy, CEO of ACLEDA put it, "The IMF is always very conservative... If you look at the past five years, the banking sector in Cambodia has seen very strong growth in loan portfolios of between 20 and 25 percent but at the same time, non-performing loans are still low." (Reuters News 2013). In addition, the credit growth largely reflects the increase in trade credit to finance growth opportunities and was driven by just a few banks: Industrial and Commercial Bank of China (ICBC), ALCLEDA and Canadia Bank were responsible for almost half (45 percent) of the loan growth in 2012 (Knuckey 2012).

Considered overall, Cambodia's financial sector faces a number of risks:

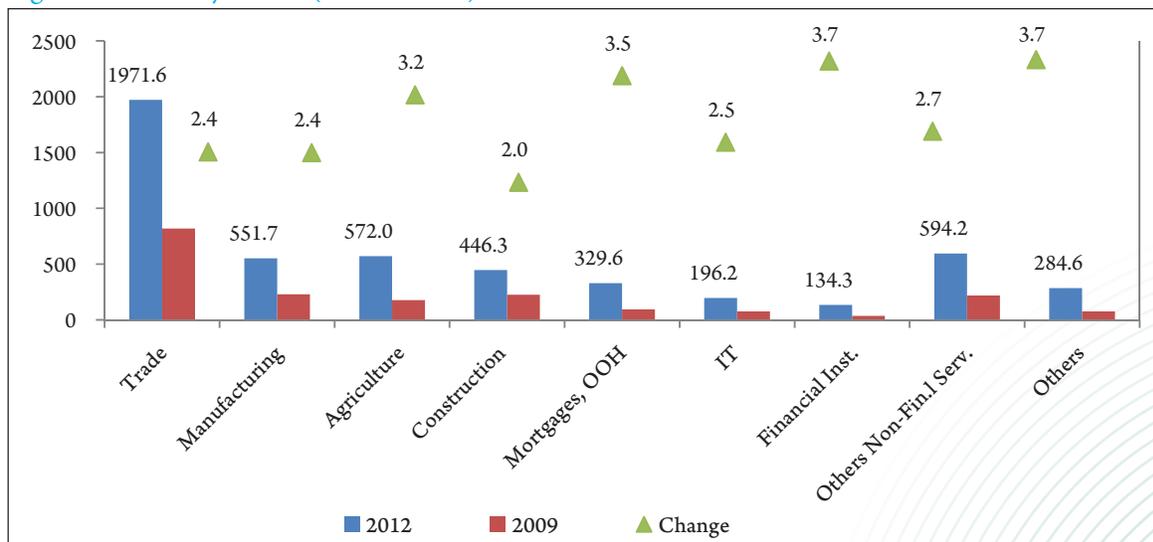
- Absorbing an unskilled workforce (by bank standards) into the sector because of the lack of appropriate and advanced skills available,

coupled with rapid credit expansion, could affect the quality of loan risk assessment and risk management. This, in turn, could create systemic risks and increase financial fragility.

- The absence of a lender of last resort (i.e. a central bank with the financial resources and authority to step in during liquidity shortage) due to high dollarisation leaves the country vulnerable to liquidity risks.
- Political instability could trigger bank runs amid fragile public confidence.
- The high number of banks coupled with the limited technical and human resources could pose a formidable challenge to regulatory authorities.
- External risks, such as the normalisation of monetary policy in the US ("tapering", i.e. a reduction of the Federal Reserve's quantitative easing, or bond buying programme) due to potential capital outflows from developing and emerging economies, China's slowdown, or stagnation in EU countries, could pose macroeconomic risks to Cambodia through trade and financial channels. Such external risks need to be monitored closely given Cambodia's structural (narrow base) and macroeconomic vulnerabilities (limited policy space to respond to shocks).

These risks need to be managed well in order to maintain the financial-macroeconomic stability necessary for growth.

Figure 4: Credit by Sector (USD million)



Source: NBC 2009, 2012

Financing Agriculture⁴

Agricultural development can be a key engine of economic growth and can provide resources for other sectors such as education, health and overall social development. Despite its huge potential to drive growth and lift the majority of the population out of poverty, the sector is facing many constraints ranging from technology (i.e. post-harvest technologies), infrastructure, price volatility and access to finance. In 2012, credit to agriculture was around 10 percent of total credit, which is relatively low compared with the region as a whole.

As Figure 4 shows, loans to agriculture have increased by a factor of 3.2, from USD177 million in 2009 to USD572 million in 2012, which is 9.6 percent of total credit (NBC 2012). However, farmers still face limited seasonal finance for purchasing inputs, while millers, who are estimated to need around USD500 million to buy paddy for export processing, lack working capital.

A number of challenges hinder the financing of agriculture. First, high risks related to climate hazards, flooding, irregular rainfall, lack of irrigation, and inappropriate fertiliser use make banks and MFIs reluctant to extend credit to agriculture, or compel them to charge higher interest rates to compensate for those risks. Second, the lack of adequate collateral (proper land titles) can also create obstacles to rural and agricultural finance. The resulting credit shortage can make local millers and entrepreneurs less competitive than merchants from neighbouring countries like Vietnam and Thailand.

MFIs and ACLEDA play an important role in providing loans to the rural sector, where agriculture is the main livelihood source. In 2012, 18 percent of ACLEDA loans went to agriculture, which is high compared to other commercial banks in Cambodia. However, the credit supply is still far from meeting credit demand in the agriculture sector. Moreover, the link between commercial banks and agriculture finance is still limited.

⁴ This section is partly based on the DRF policy roundtable organised by CEA in November 2013. Speakers included Chan Sophal (HARVEST), HE Dr Mey Kalyan (SNEC) and Dr In Channy (ACLEDA Bank).

There have also been discussions about how to further reduce interest rates on loans and how to address the limitation of the supply of riels, which are more in demand in the rural economy than in the urban economy. Currently, the interest rate is determined by a combination of the costs of capital, operating costs, and margins. A consistent monetary policy for riel circulation needs to be discussed further.

Limited access to financial services is a constraint on agricultural development. Nonetheless, from a business perspective, this constraint should be viewed as an opportunity for banks. The challenge for policymakers then is to address bottlenecks and to facilitate financial outreach to the agriculture sector.

The Road Ahead

Increased and sustainable access to financial services and a stable, resilient financial system will be essential for the next phase of Cambodia's growth. Expanding services and improving outreach should be promoted to reach large segments of the population and to broaden the scope of savings mobilisation and credit provision for key sectors such as agriculture. There is also a need to better understand how to extend access to financial services, especially for poor people in hard-to-reach areas where opportunities may be scarce and who might have limited knowledge about how to access available financial services.

Moving forward, Cambodia should pay attention to the following points:

- Tapping private sector initiative and investment, and easing financing constraints in key sectors such as agriculture
- Monitoring and supervising factors that potentially contribute to excessive credit growth
- Regulating the proliferation of foreign bank loans in Cambodia
- Growing interconnectedness and sectoral exposure (for example, real estate)
- Dollarisation, which constrains the lender-of-last-resort role
- Growing supervisory burden amid the fast growing financial sector

- Human resource constraints: the skills shortage needs to be addressed over the medium- to long-term.

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About DRF

The Development Research Forum (DRF) of Cambodia was established following the All-Partners Forum organised by the International Development Research Centre (IDRC) in September 2007.

The DRF vision is of a high capacity, professional and vibrant Cambodian development research community. Its goal is to support and strengthen the capacity of the Cambodian development research community.

The DRF partnership involves the Cambodia Development Resource Institute (CDRI), Cambodian Economic Association (CEA), Learning Institute (LI), National Institute of Public Health (NIPH), Royal University of Agriculture (RUA), Royal University of Phnom Penh (RUPP), Supreme National Economic Council (SNEC) and the International Development Research Centre (IDRC).

In DRF Phase II 2012-15, with financial support from IDRC, the partners intend to work together to build research culture and capacity and to share research knowledge through workshops, policy roundtables and symposiums as well as training and online discussion (www.drfcambodia.net) on six research themes: growth and inclusiveness, governance of natural resources, social policy – education, social policy – health, agricultural development, and Cambodia and its region.

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