Cambodia and Capital Flows: Leaning Against the Wind?

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Questions

Amid strong potential growth and regional dynamics:

- What can we learn from international experience in managing capital flows?

- What are the risks associated with capital inflows in Cambodia and how can we manage it?

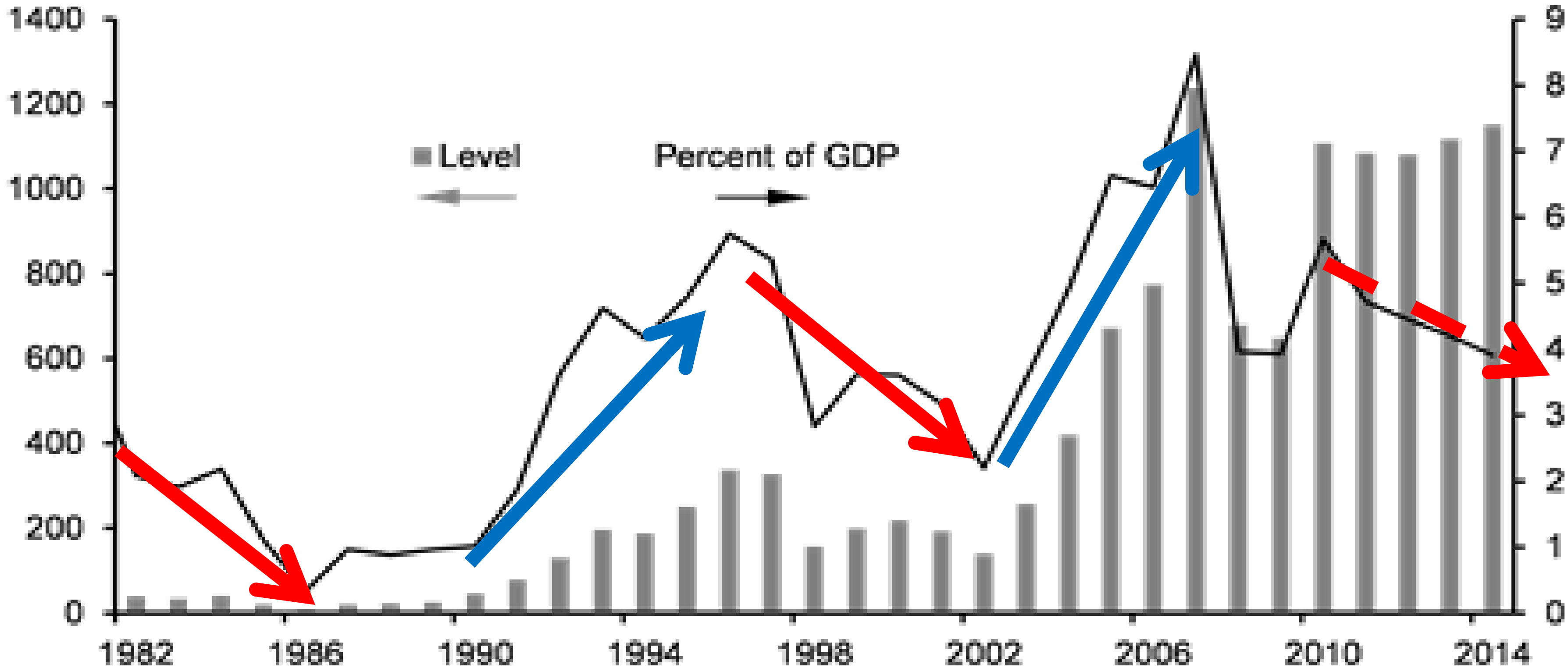
Capital flows can be beneficial for host countries if properly managed.

- Address domestic financing constraints and boost investment
- Contribute to local financial sector development
- Transfer of technology and know-how (FDI)
- Smoother path of consumption

However, countries have faced macroeconomic risks due to: the procyclicality, volatility, risks of sudden stop and reversal of capital flows.

Private Capital Inflows to Emerging Market Economies ($billion)

Percent of GDP

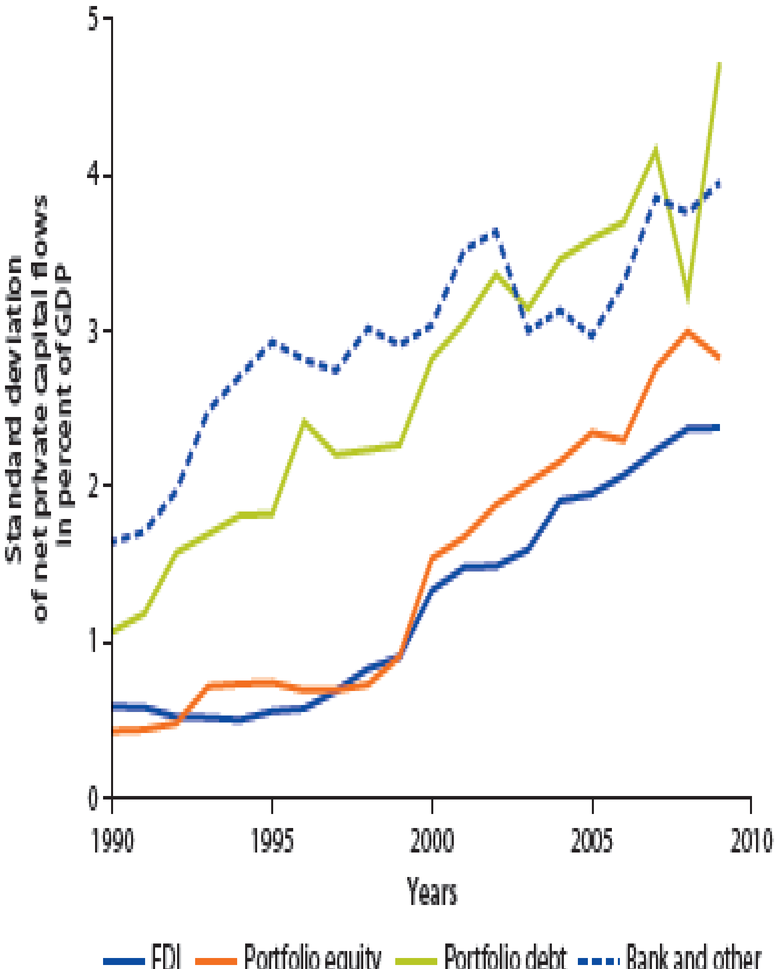


IIF

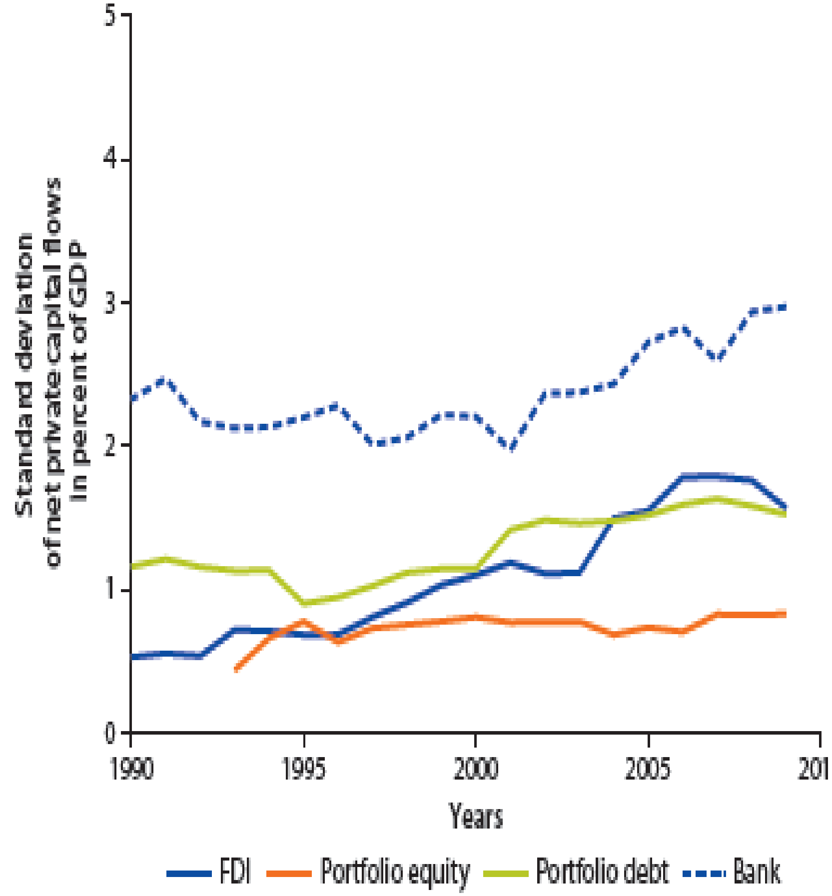
http://www.iif.com/press/press+406.php

Bank flows has been the most volatile in EM

Advanced Countries
(Median)

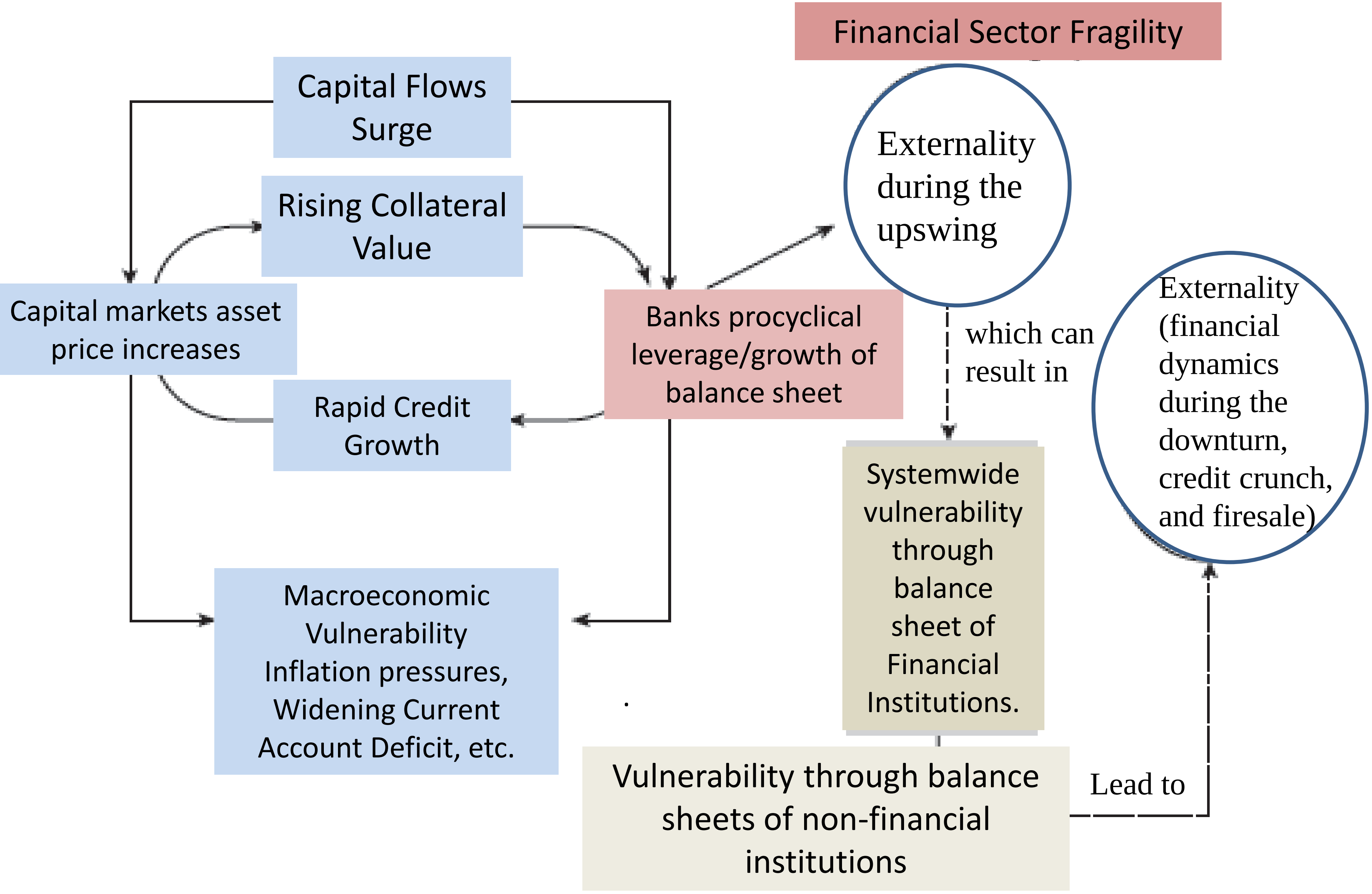


Emerging Countries
(Median)



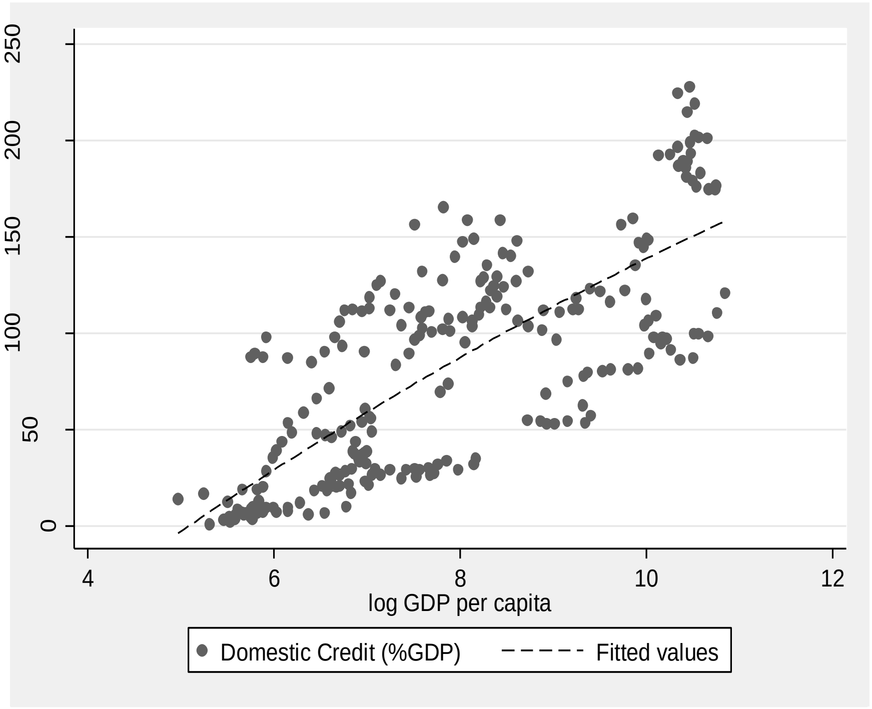
Source: Based on data from IMF World Economic Outlook April 2011.
Note: FDI = foreign directive investment; GDP = gross domestic product.

Capital Inflows and the Potential Buildup of Vulnerability

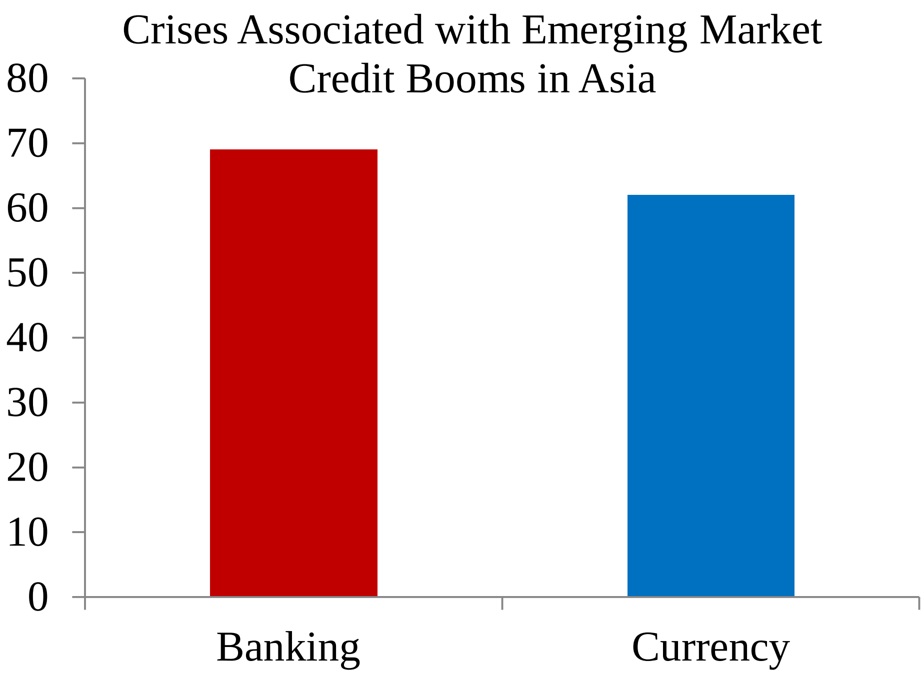


Financial Sector: Vigilance on capital inflows & credit growth

Credit and income level are highly correlated. But, 2/3 of credit boom are associated with crises

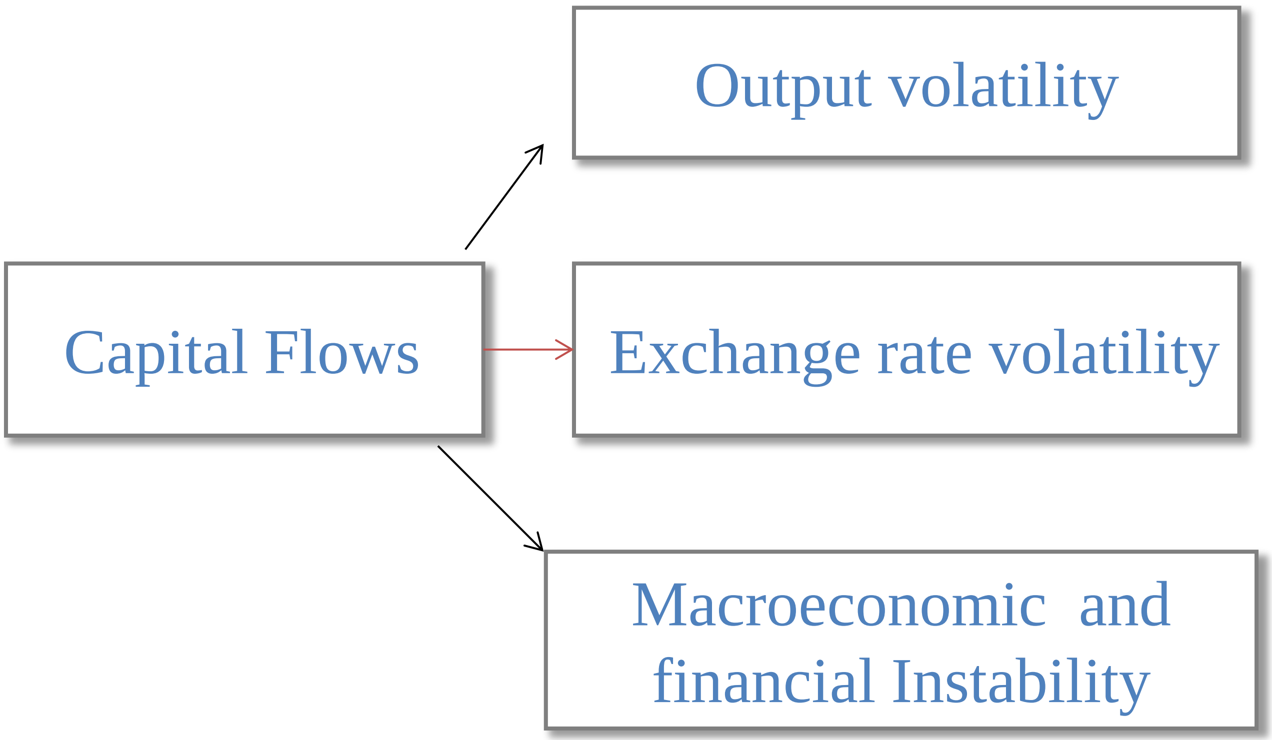


147 (123) crises, 1970-2012



Source: World Bank Data (WDI, 2013)

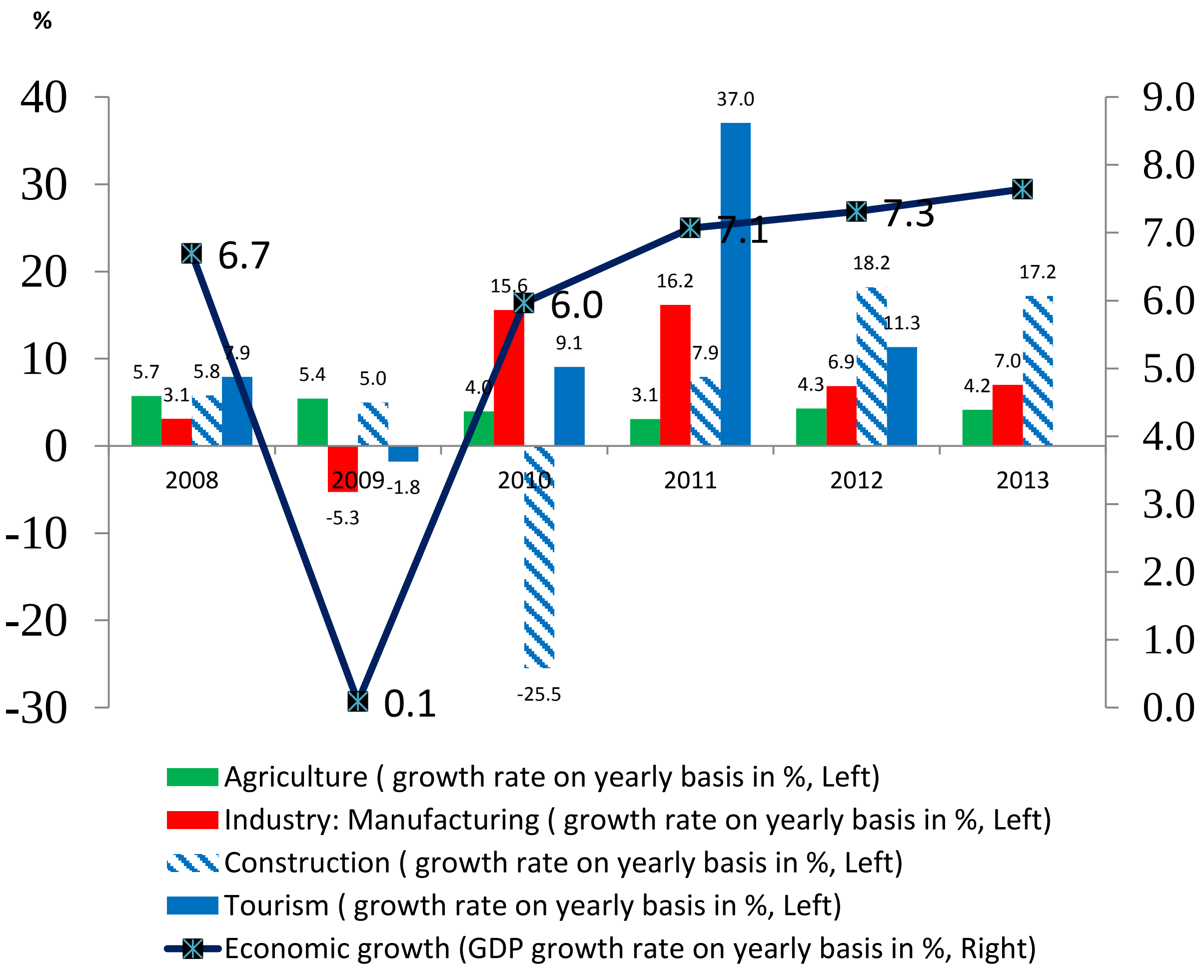
Risks: Magnitude, volatility, and reversal could destabilize macroeconomic stability



Capital Flows Measure/Macroprudential Measures.

What are the risks associated with capital inflows in Cambodia and how can we manage it?

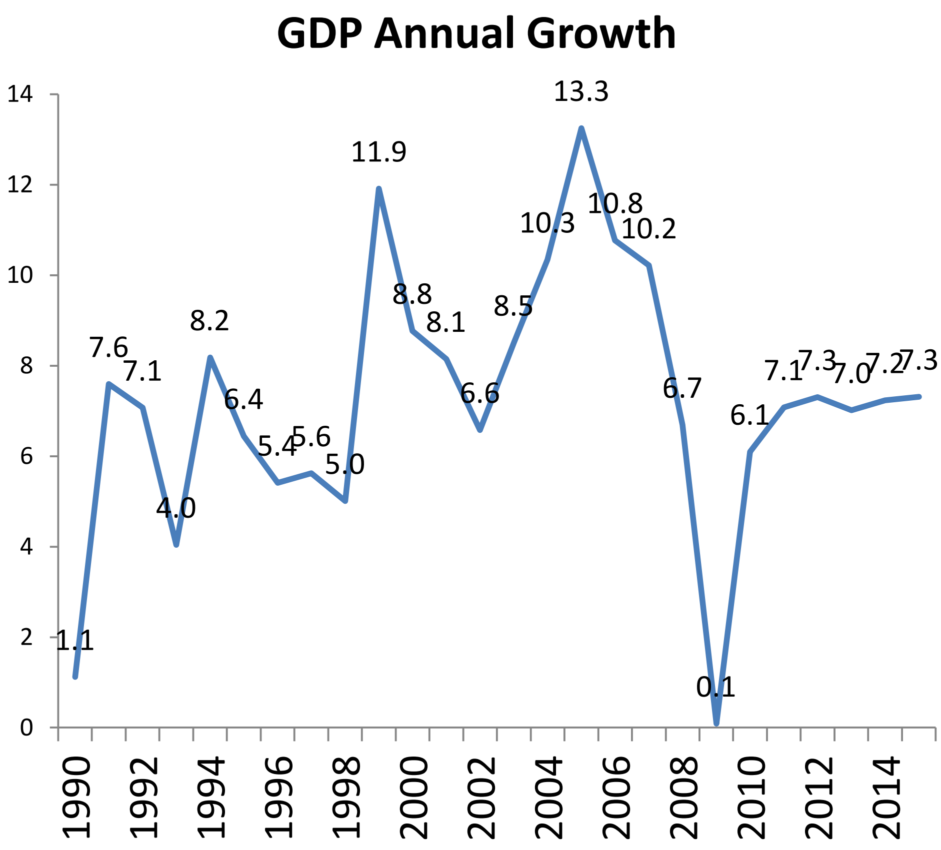
Cambodian economy remains robust, driven by strong agricultural growth, resilient exports, rebounding construction and robust tourism.

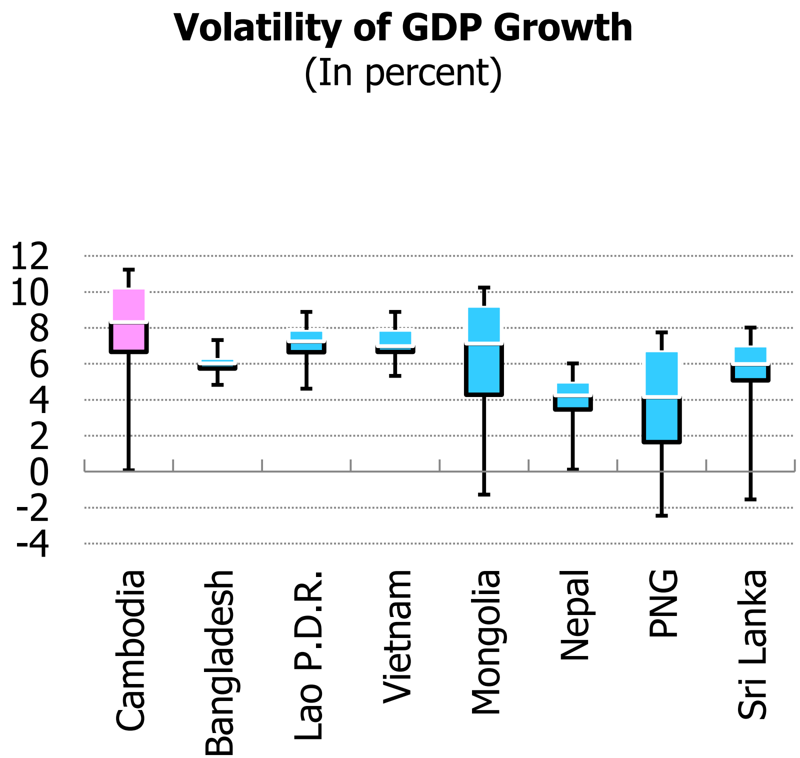


7%

Source: MEF, NBC (2013)

However, Cambodia's growth has been more volatile than peers





Source: IMF (2011)

shocks can be magnified given Cambodia's narrow base and limited policy options

Structural Vulnerability

Macro Vulner.

Risk

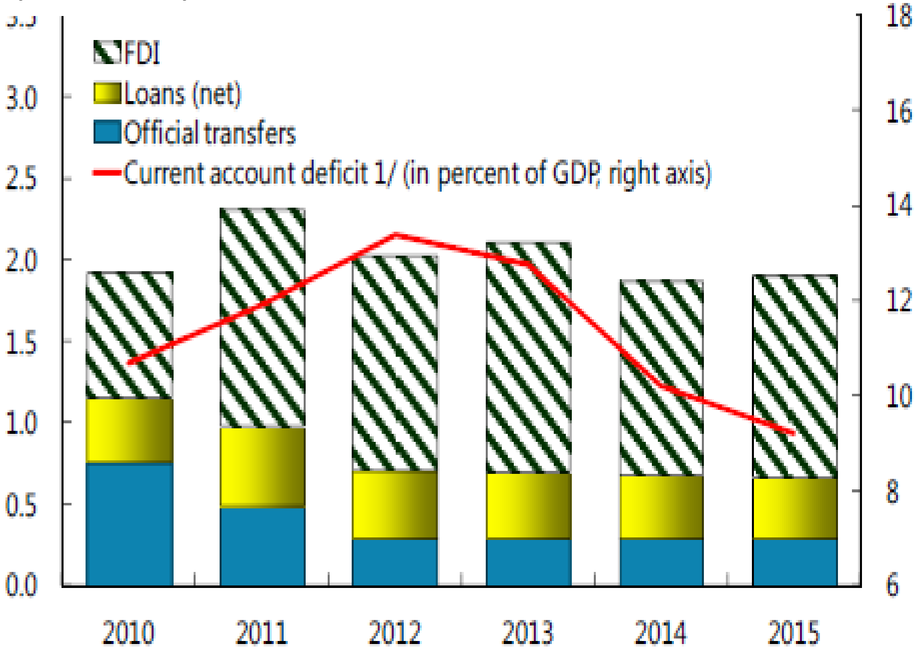
Exposure from country Characteristic
- Export Concentration,
- Commodity Composition of export

Subject to policy and fundamental
- fiscal policy
- monetary policy
- CA deficit

"Shocks" — things that can get us off-track— as countries go through various growth phases

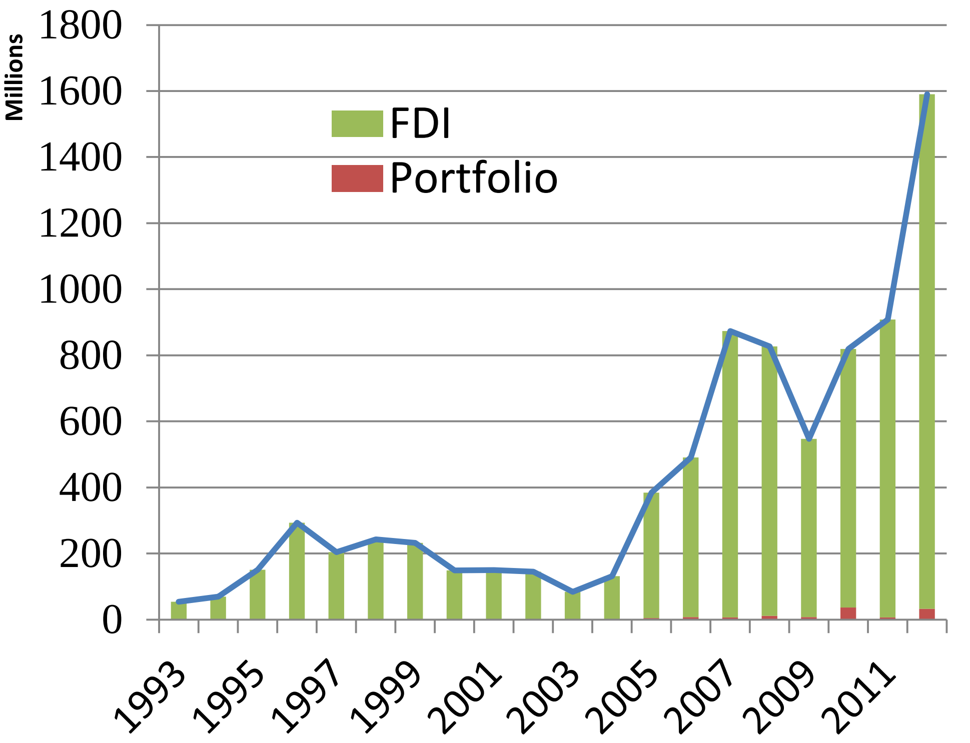
The current account deficit remains fully funded by Capital Inflows (Largely FDI and ODA)

Current Account Deficit and Capital flows ($ billion)



1/ Current account balance excluding official transfers.

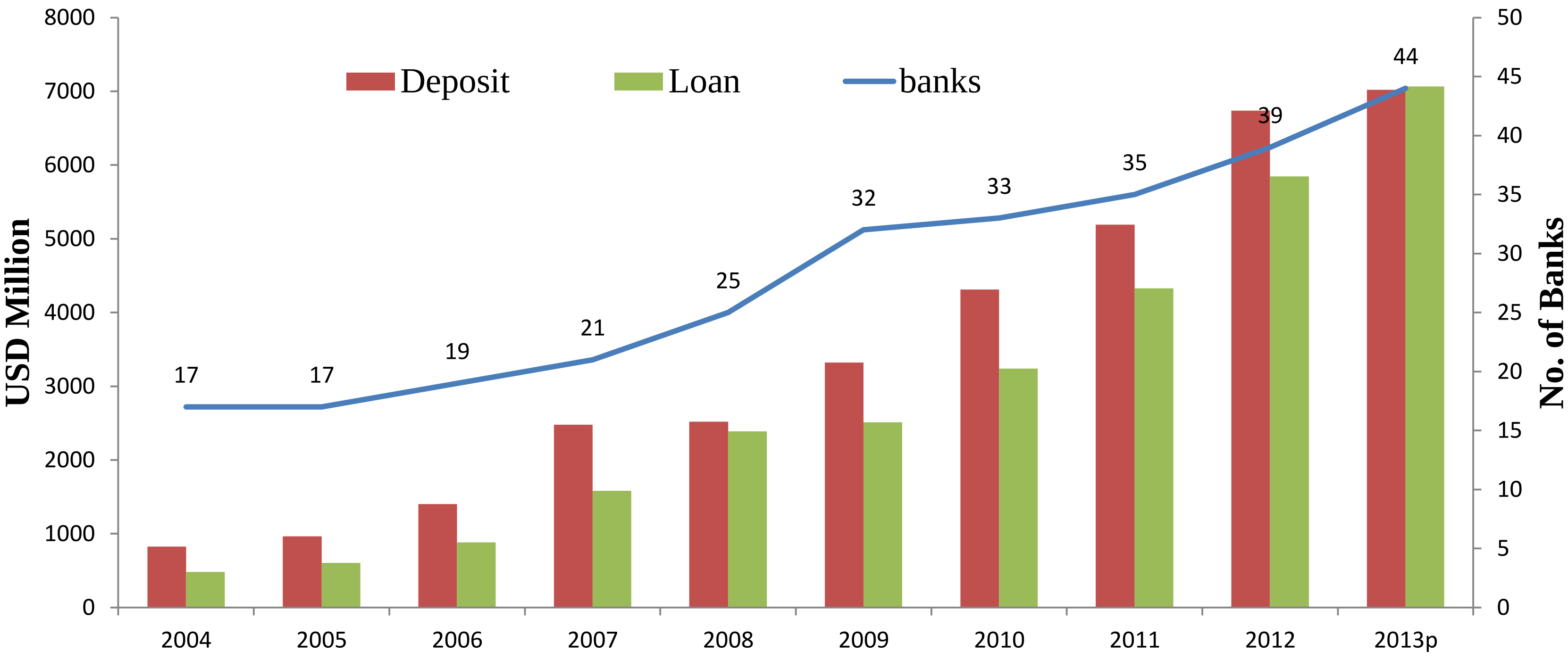
Source: IMF (2014)



Source: World Economic outlook database

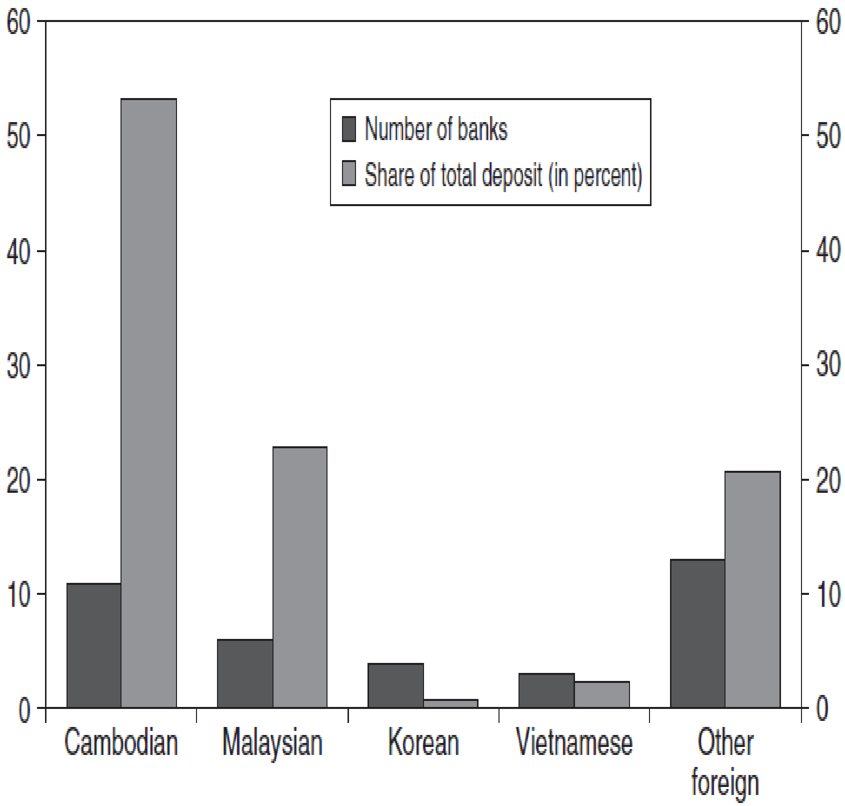
It is reflected in a rapidly growing financial sector in which 2/3 of banks are foreign owned; high concentration.

Loans +35%(2012), 21% (2013) Deposits+30% (2012)



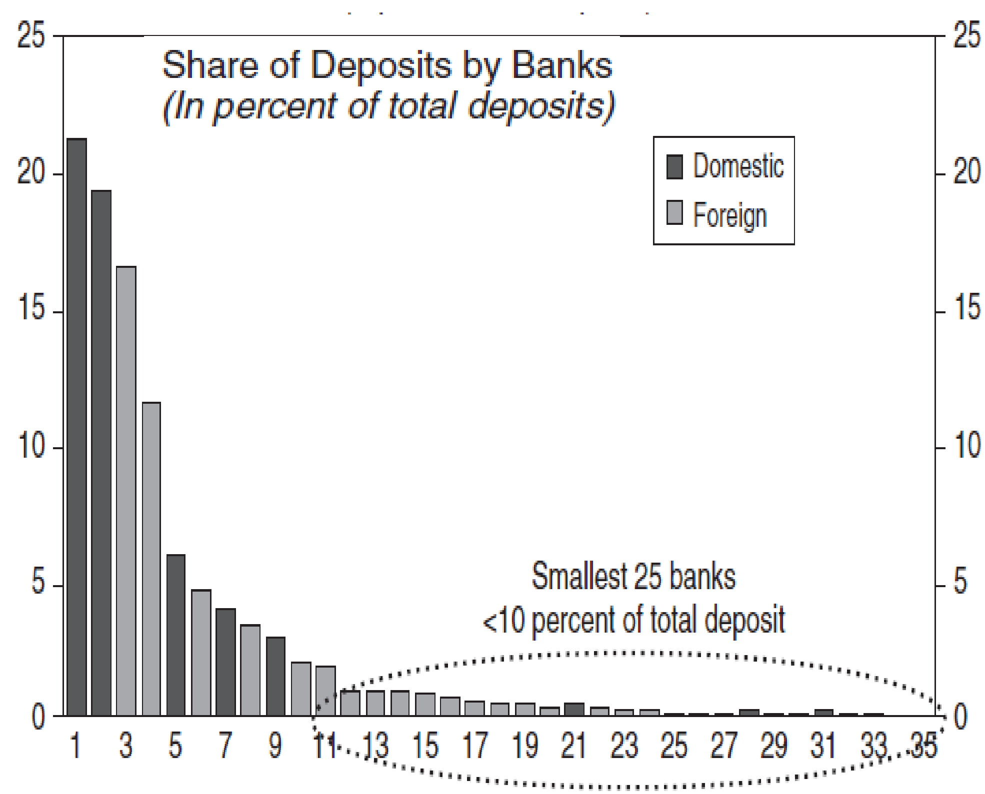
Source: NBC (2013)

2/3 of the banks and 5 of the top 10 are foreign owned. (half the total deposit)



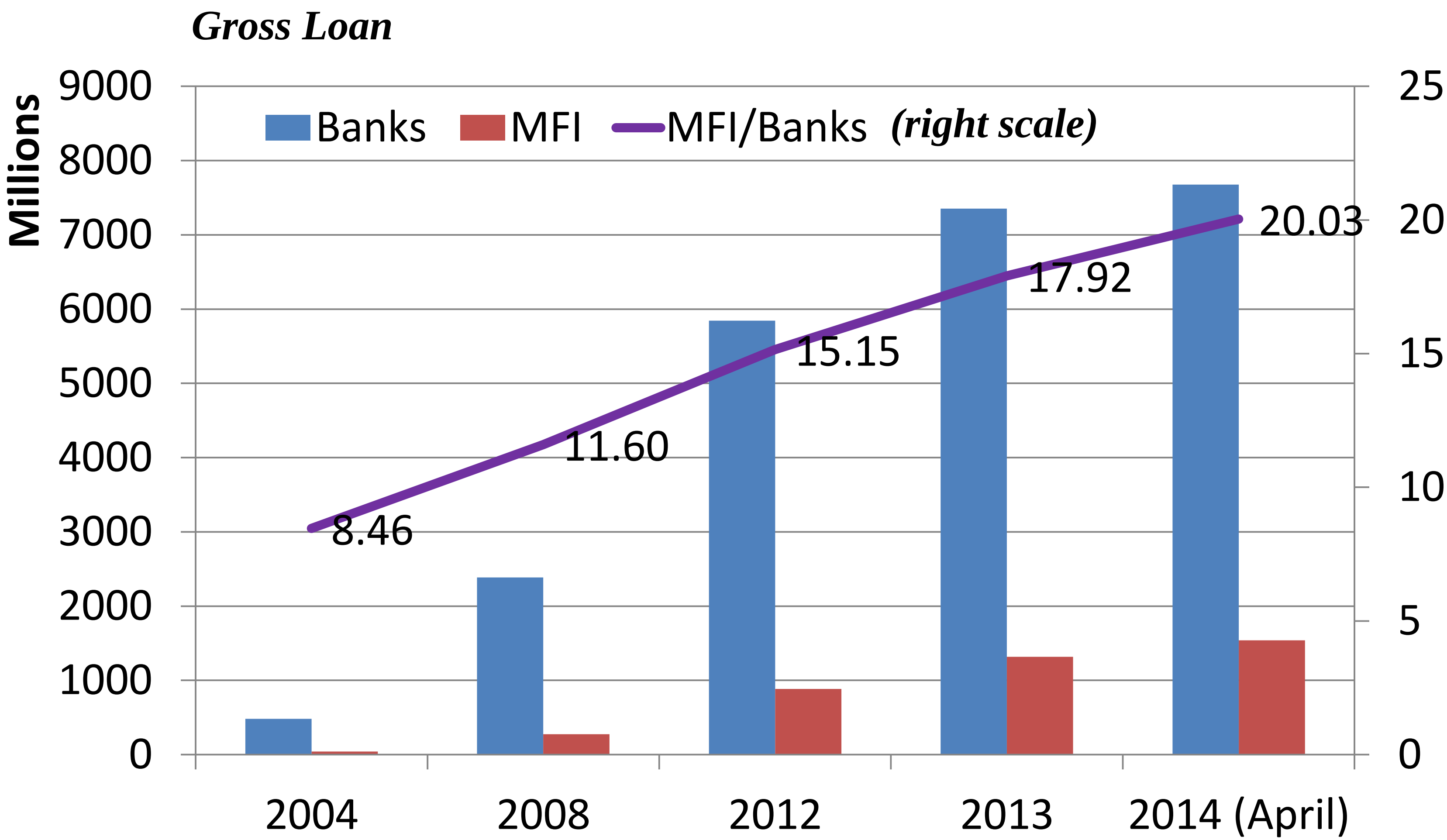
Source: National Bank of Cambodia.

Note: Defined as the residency of majority ownership. "Other foreign" includes banks from Australia (ANZ Royal), China, India, Japan, Kazakhstan, Taiwan Province of China, Thailand, and the United States.

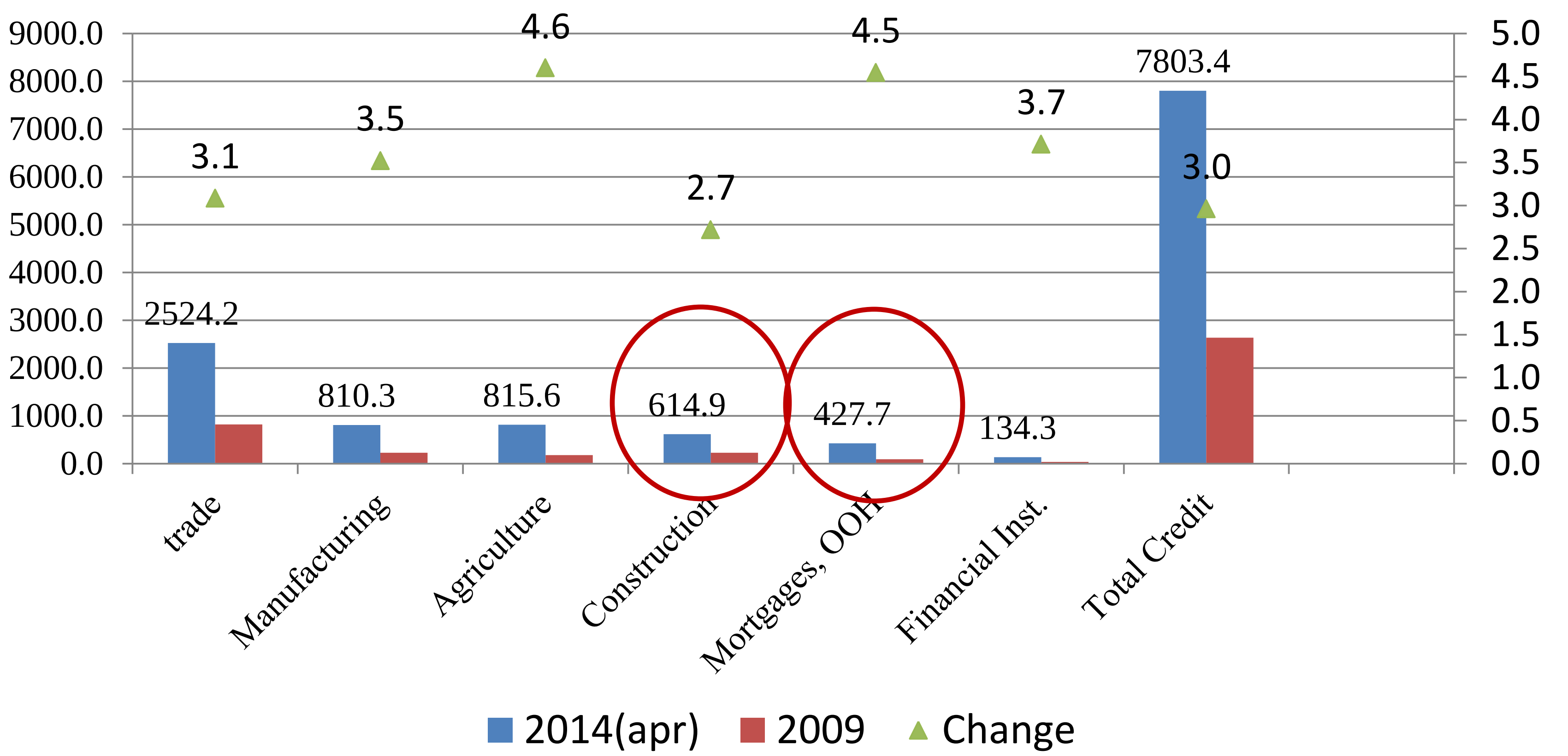


Source: National Bank of Cambodia.

External capital-funded MFIs is also growing fast

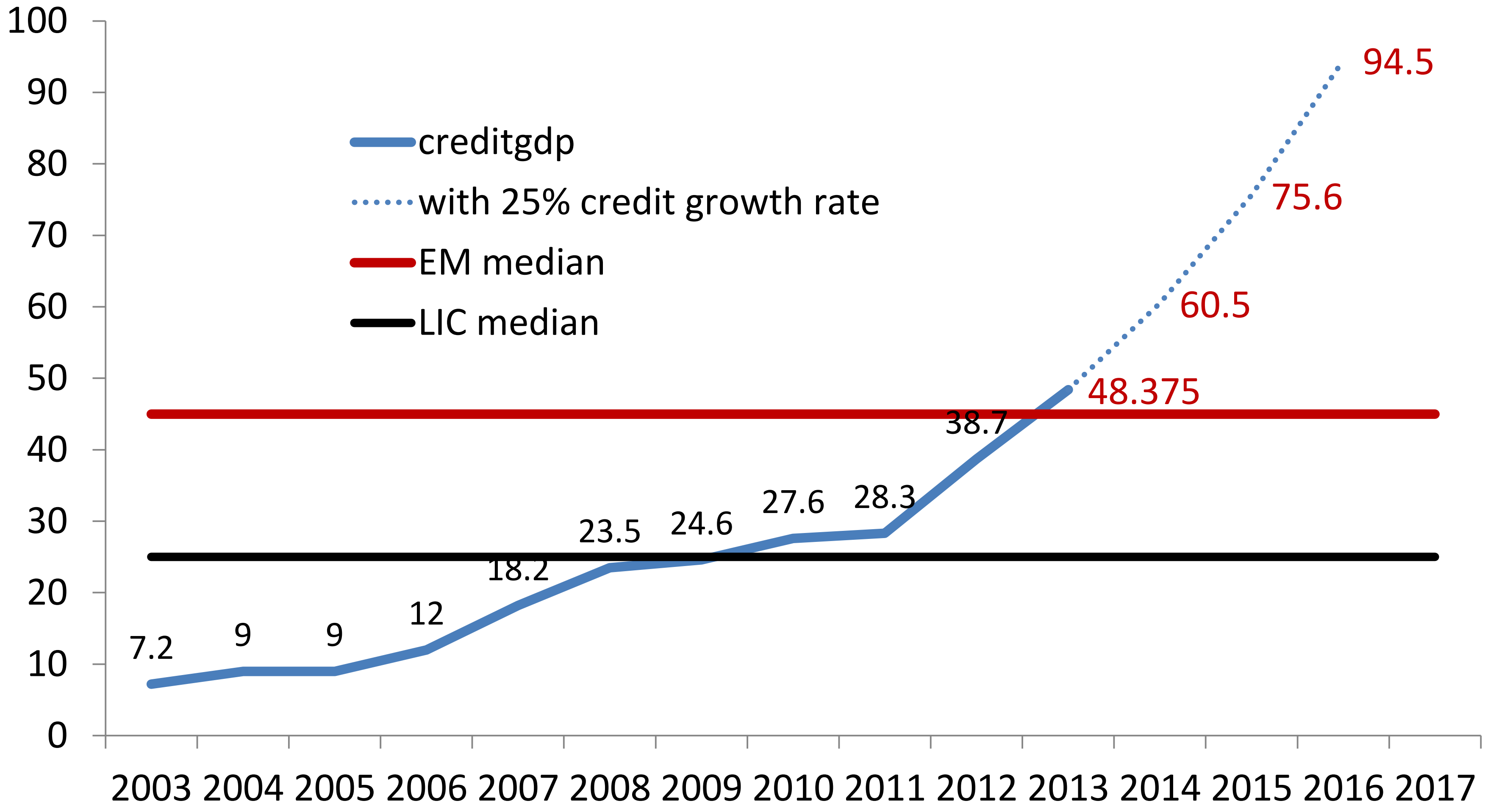


Credit growth took place in key sectors but also in asset markets where risks could build up quickly.



Source: Author's calculation based on NBC's data

The credit/GDP ratio should be already exceeding the median for more advanced Emerging economies, suggesting for a careful expansion and vigilance.



Source: Author’s calculation based on NBC, IMF (2012)

Risks and Current Policy Stance

Rapid credit growth, increasing banks flows from abroad, and greater real estate exposure poses macro-financial risks.

Bank funding from abroad is not subject to prudential limits and could stop with tapering in the US and other external shocks, leading to volatile liquidity and credit conditions.

NBC Tools and Stance

- Strengthened supervision
- Reserve Requirement (12.5%)
- Minimum Capital Requirement (statics) (37.5 million USD)
- Limit net FX open position (20%)
- No Reserve Requirement on Foreign Funding
- Free flows of foreign Funding (MFI and bank's external funding)

Balancing Financial Access-Stability

Photo by Eng Sothy

Leaning Against the Wind?

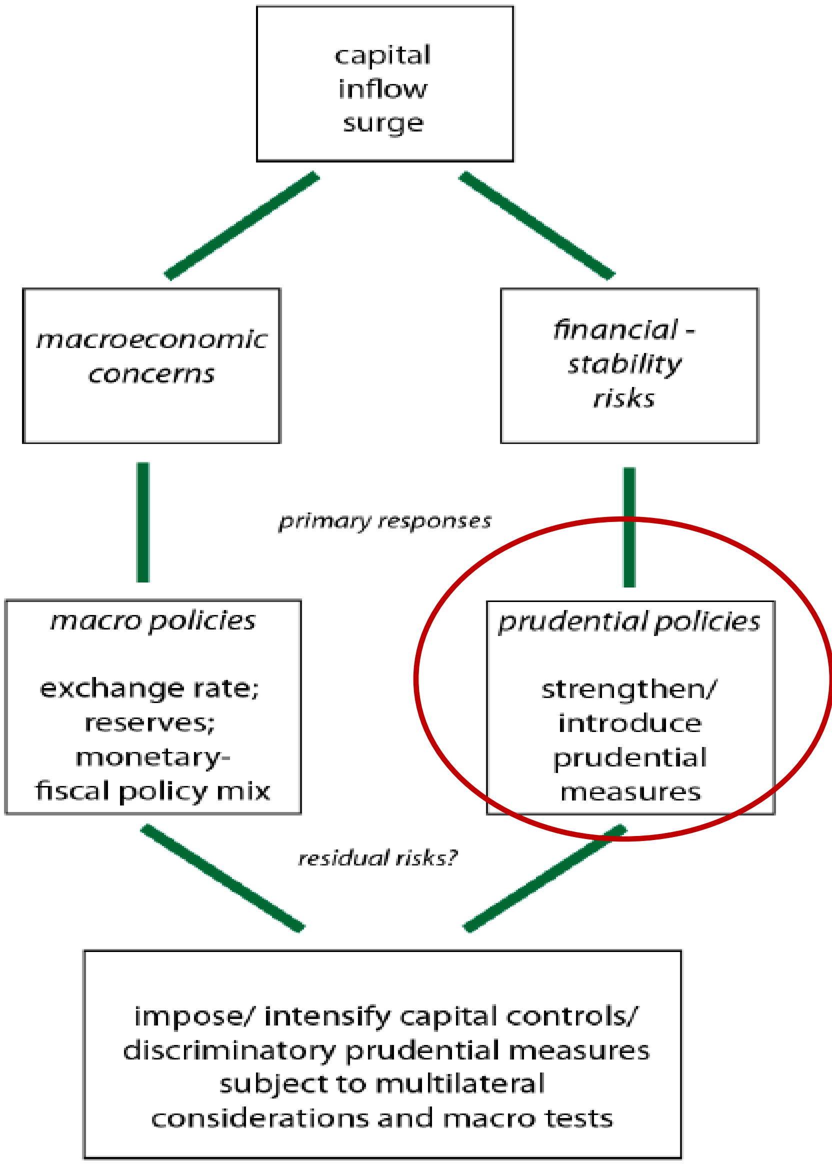
Macro Prudential Measures and CFM

Micro PP improves individual institutions' resilience to risks and reduce systemic risks. Examples:

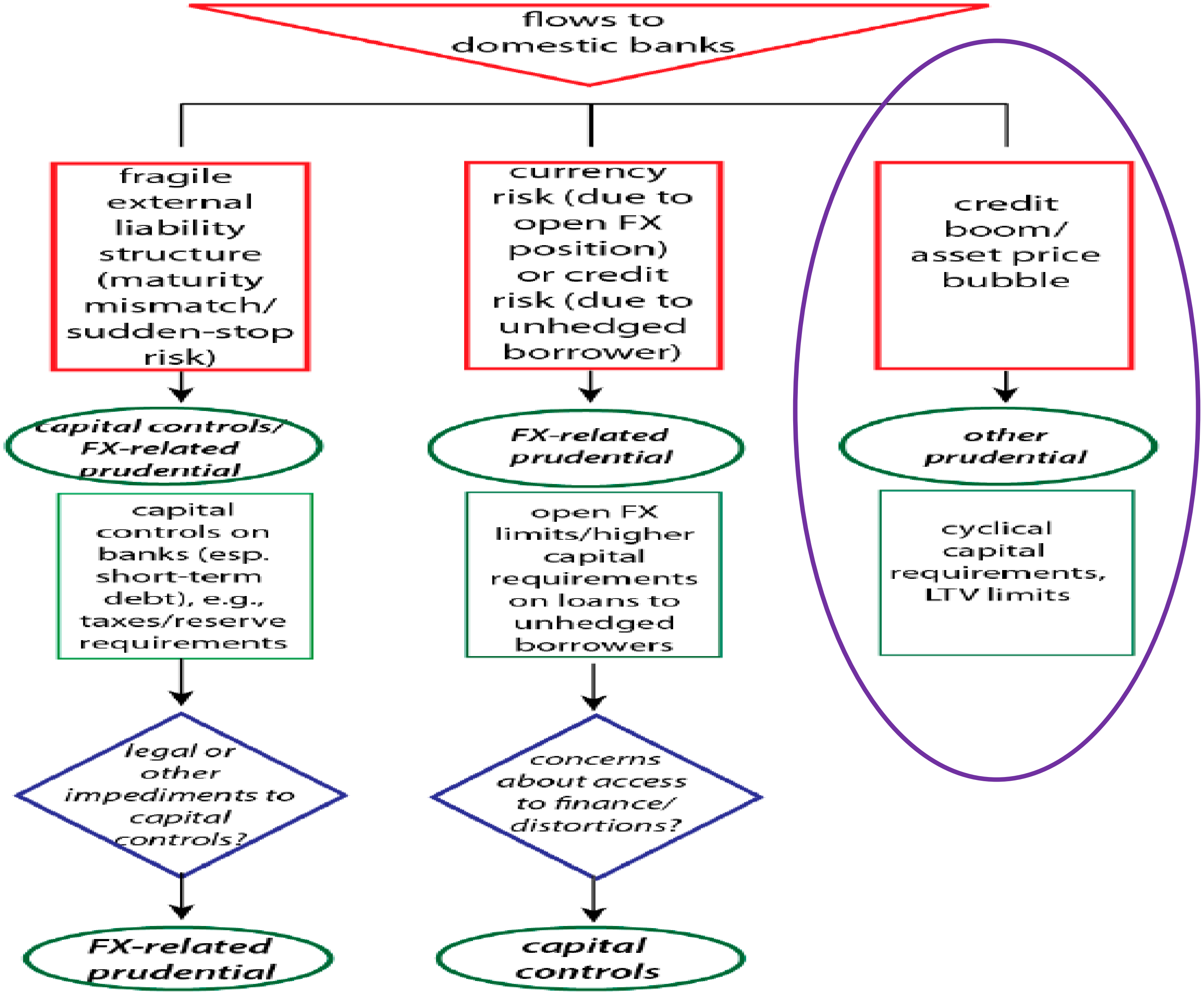
- Forward-looking provisioning of expected loss
- Caps on LTV, DTI
- Minimum capital requirement

Macro PP aims at systemic risks. Examples:

- Cyclically varying provisioning requirement
- Cyclically varying LTVs
- Countercyclical capital buffer (Basel III)
- Caps on credit growth
- Higher reserve requirements



Choice of instruments to mitigate risks associated with flows through the banking system



1/ Assuming macro policy options have been exhausted, and taking due account of multilateral considerations.

Discussion

- Macro prudential policies can help control banking system vulnerability, and are much more effective in booms than in busts.

- Macro prudential framework requires two elements:

  -A set of indicators (Credit/GDP, core and non-core bank liabilities, etc..), and

  - Tools : LTV, cap on DTI, leverage caps. levy on short-term FX liability. Reserve Requirement on Foreign Funding.

- Further Research on experience and capital flows management in dollarized economies (Eastern Europe's experience)

Road ahead: *Positioning for a bumpy ride with broader base and macroeconomic policy and prudential measure*

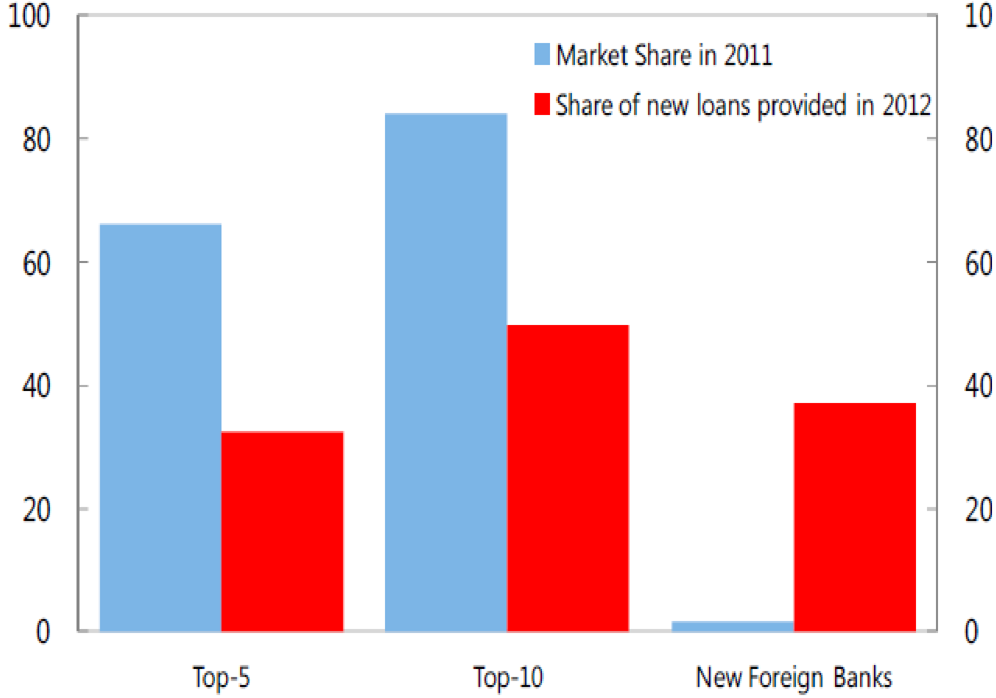
Cambodia is on a high-speed (but relatively narrow) highway => Costs of inadequate vulnerability management will likely be higher than regional peers at comparable stages.

- The trend clearly suggests for vigilance (Macro prudential measures)
- Macro policy: adopt forward-looking, risk-based approach.
- Develop interbank and FX market to enhance effectiveness of monetary policy operation
- Data collection and more research for policy judgment are urgent (indicators for risk assessment and supervision)
- Consider enforcing the reserve requirement on foreign funding.
- Carefully consider Loan to Deposit (LTD), and LTV Ratio limits for high risk sectors.

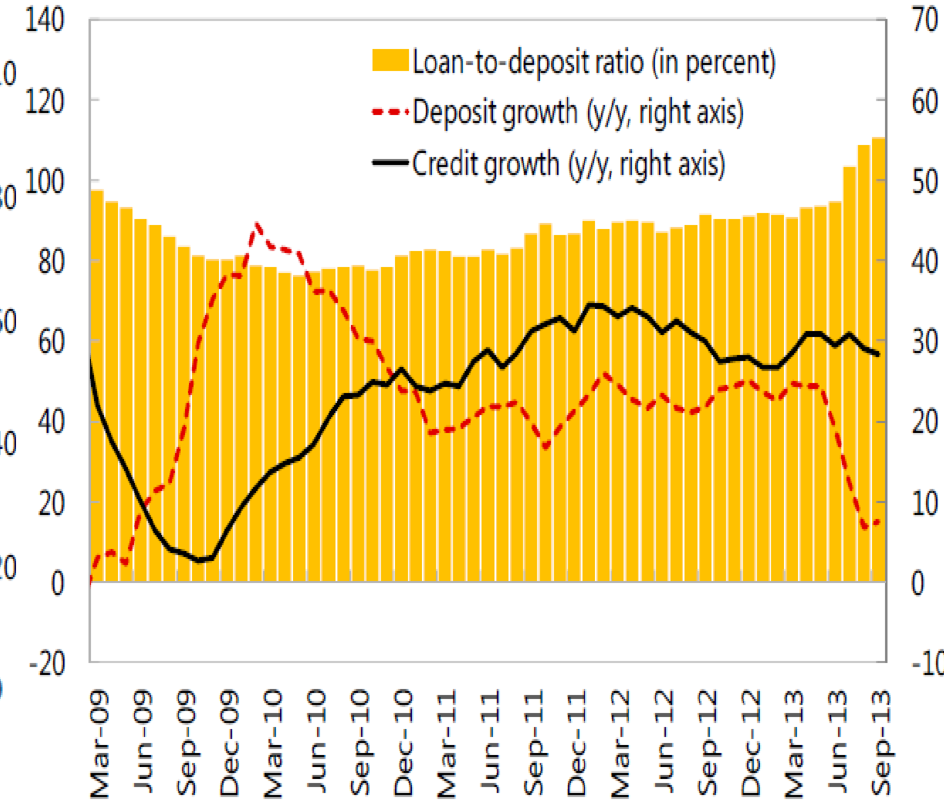
Constant surveillance on:

- Increasing amount of foreign liability funded credit growth;
- Growing interconnectedness within/between sectors
- Shadow banking

Relative Shift of Market Share: new Banks (in percent)



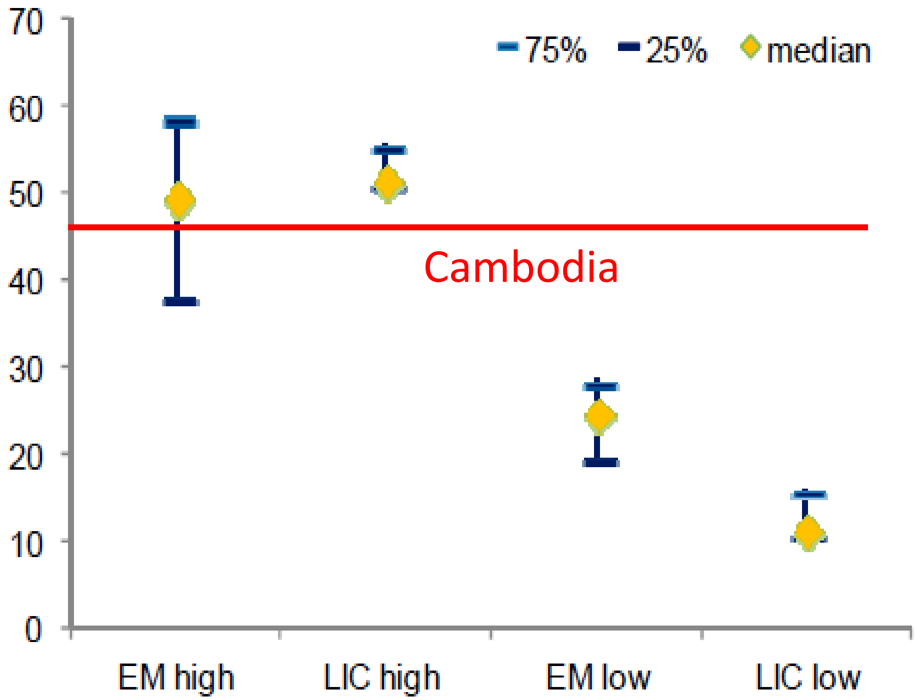
Deposit and Credit Growth, 2008-2013



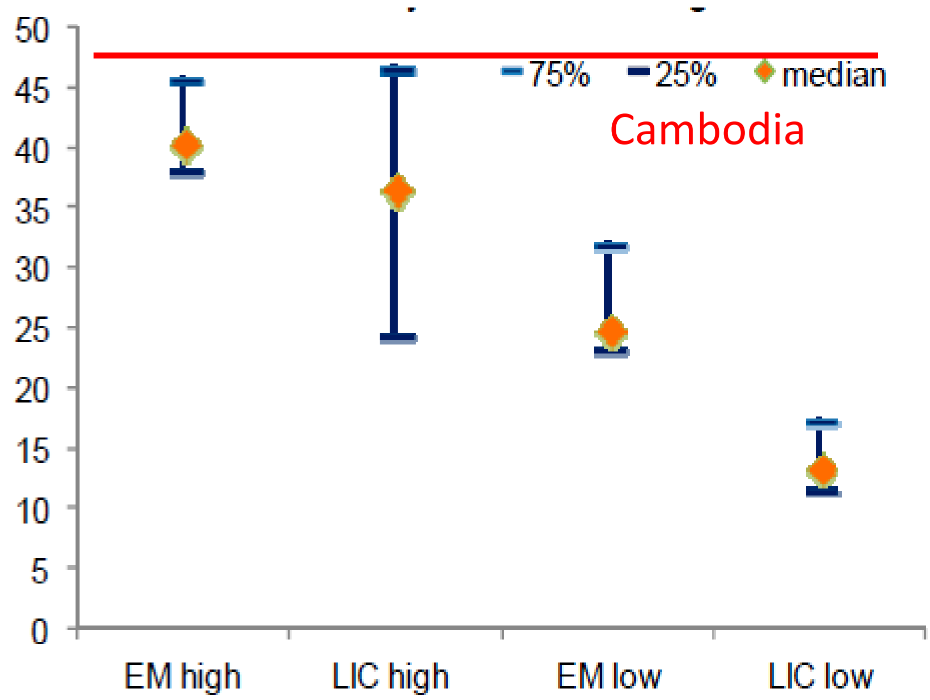
Source: IMF (2014)

Credit level seems to exceed the institutional capacity, and the level of financial openness.

Private Credit by Governance Quality



Private Credit by Financial Integration



Source: *Fin Stats (2011), Kaufman et al. (2010); Lane and Milessi-Ferreti (2010)*