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MINISTRY OF ECONOMY AND FINANCE

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Cambodia: Macroeconomic Management In Response to the Global Financial Crisis

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The current financial crisis being witnessed in the United States and other developed countries is unprecedented since the 1930 Great Depression. Although it represents a major challenge for ASEAN and Asia as a whole, its impact on ASEAN economies is expected to be mitigated. Our region had gone through these painful experiences 10 years ago, when the Asian Financial Crisis swept through the region and left behind considerable damages of the financial tsunami. The current financial crisis, coupled with high inflation, would lead to lower economic growth for ASEAN countries.

Cambodia will fare much better than other countries in the region of the world, due to the lack of direct exposure of Cambodian banks to the US subprime. Nevertheless, Cambodia is currently faced with two important, albeit manageable challenges: (i) indirect impact of the global financial crisis; and (ii) high inflation.

I. Macroeconomic Performance in 2008

High economic growth and strong political stability that Cambodia has experienced during the last decade has been recognized by many as the "Miracles on the Mekong". The new Royal Government of Cambodia resumes its duties in the fourth legislature with renewed dynamism and commitment to carry on its noble and historical mission with firm commitment and renewed determination to accelerate development and implementation of the comprehensive, in-depth state reform.

Economic growth was robust, averaging at 9.4 percent during the last decade, 10.6% during the last five years, 2003 to 2007, with the record high of 13.3 percent in 2005, 10.8 percent in 2006 and 10.2 percent in 2007. Growth is projected to be lower at 6.8% in 2008 and 4.8% in 2009, reflecting the global economic slowdown. Inflation is expected to be 15.5% in 2008, but will be reined in to a single digit in 2009.

Our international resources position has been favorable and was doubled during the last two and a half years only, from $1 billion in 2006 to $2 billion in June 2008. It took 12 years for Cambodia's gross foreign reserves to increase from $100 million in 1994 to $1 billion in 2006.

1.1. The Banking Sector

Total assets of commercial banks grew rapidly during the last three years. The grow rate was 21-24% in 2003-2005, but accelerated to 39% in 2006 and 74% in 2007.

However, Cambodia's banking system remains sound, well capitalized and highly liquid. The capital adequacy ratio (net assets or net worth/ weighted assets according to the degree of risks) was 26% in 2007, well above the regulatory minimum of 15%.

Cambodia's banking system is highly liquid. The liquidity ratio (liquid assets/ total assets) was 50% in 2007. Non-performing loans (NPLs) declined from 9.5% in 2006 to 3.4% in 2007 and further to 2.6% in June 2008. The profitability of the banking sector has doubled last year.

Bank deposits and loans continue to grow in 2008, reflecting public confidence, despite the devastating global credit crunch. The last three years have seen phenomenal growth in bank deposits, reflecting increase in capital flows, foreign direct investment, portfolio investment, and the growth in exports of goods and services (especially a growing tourism sector). Bank deposits grew 47% in 2006, 61% in 2007 and 36% in the first half of 2008, roughly $800 million in 2007 and US$1 billion in 2008.

Domestic credit to the private sector also grew rapidly during the last three years. While domestic credit to the private sector was growing on average 30% annually in 2003-2005, it grew at the rate of 53% in 2006, 78% in 2007 and 70% in the first half of 2008. Year on year, credit grew 100% in the first quarter of 2008. Cambodia's banking system is highly centralized, and the centralization of commercial banks continues to grow during the last few years, with the five largest banks account for 71% of loans.

Such rapid growth poses some challenges for the banking sector: (i) the quality of loans might have degraded; (ii) the rapid expansion of the banking sector has outstretched the central bank (National Bank of Cambodia)'s capacity to supervise commercial banks; and (iii) increase exposure of banks to real estate.

To sustain growth and ensure the soundness of the banking sector, the authorities have taken steps to recapitalize bank, improve prudential regulations and strengthen supervision:

- Increase reserve requirements of commercial banks from 8% to 16% in order to absorb liquidity from the economy, especially to tighten lending bank loans to the private sector, following sharp increase in the credit to the private sector;

- Limit commercial bank's exposure to some high risk sectors, especially the real-estate trading, by introducing a 15% ceiling for loans to real estate trading;

- (By an NBC Prakas dated 19 September 2008) increase the minimum capital from 50 billion riel ($13 million) to 150 billion riels ($36.5 million) for commercial banks, unless they have an influential shareholder that is a bank or financial institution with an investment grade rating from a reputable rating agency; and increase minimum capital to 30 billion riels ($7.3 million) for a specialized bank,

1.2. Financing Economic Growth

Cambodia has witnessed increase in both foreign direct and portfolio investments during the last five years, reflecting steady improvement in investment climate and the dominant role played by the private sector in promoting social and economic development. Foreign investment funds have become more and more popular and contributed to high economic growth.

Cambodia's economic growth relies on the following for pillars:

- US$600 million in ODA a year for building social and physical infrastructures to improve environment for economic development, poverty reduction and institutional reforms;
- US$700-800 million in FDI a year for expanding productive capacity of the economy;
- US$1.2 billion in government budget for both current expenditure and capital investments to improve public service delivery. This amount will continue to increase rapidly as a result of the Public Financial Reform Program; and
- US$2.5 billion in bank loans to finance private sector projects.

Cambodia has set clear objectives of establishing stock and bond markets in late 2009 as stipulated in our Financial Sector Development Strategy 2006-2015. Progress has been made to improve accounting standards, ensure good corporate governance and prepare the corporate sector to be listed on the stock markets. The Royal Government of Cambodia invited Korean Exchange and foreign securities companies to come and joint it in this important endeavor. The stock market will become the fifth pillar of financing for Cambodia.

II. Inflation

This section is focused on:

- First, factors behind recent rise in commodity price and inflation; and
- Second, government policy measures to fight inflation and maintain macroeconomic stability and growth.

Following are factors behind recent rise of inflation. Identifying the causes of inflation is critical for applying medicine to cure inflation. There are three major types of inflation.

2.1. Increased Capital Flows and Inflation

In recent years, capital flows have played an increasingly important role in the balance of payments. Since 2005 the capital and financial account of the balance of payments rose sharply. The financial account increased by 39 percent from US$324 million in 2006 to US$451 million in 2007. The capital transfers in the form of medium and long term loans increased by 41 percent from US$123 million in 2006 to US$173 million in 2007.

The influx of private capital in the form of FDI increased by 50 percent, from US$475 million in 2006 to US$711 million in 2007. The increase in investments reflects the confidence of investors in the political and macroeconomic stability of the country. FDI is considered as "non-debt creating", because FDI does not add to external debt. Investors acquire equity in a domestic enterprise, create or expand subsidiary and there are no contractual obligations. The distinctive feature of this type of capital inflow is that it involves not only a transfer of resources, but also the acquisition of partial or full control. FDI does not create a debt obligation, and it is an important vehicle for the transfer of technical and managerial skills from abroad. The benefits of such technological transfers are often seen as outweighing the capital flow itself.

In 2007 the overall the balance of payments was in surplus by US$290 million (3.4 per cent of GDP in 2007 compared with 2.8 per cent in 2006). This outcome was underpinned by the increase in tourism receipts (US$1.1 billion), the surplus of both private and official transfers (US$748 million), the increase in concessional loans, and the increase in foreign direct investment (US$711 million).

The above capital flows have helped to finance large current account deficits associated with higher imports and higher economic growth. It also permitted build up of reserves. At the same time, sudden surges of these sizable inflows have caused some problems of macroeconomic management. There are the following concerns:

- Capital flows are temporary and can be quickly reversed;

- Capital flows have induced growth in the money supply and have caused inflation to rise, as the National Bank of Cambodia has intervened in the foreign exchange market to buy excess supply of foreign exchange in order to stabilize the nominal exchange rate. From mid 2006 to mid 2008, Cambodia's international reserve position increased by US$1 billion, while it took 12 years to increase international reserves from US$100 million in 1994 to US$1 billion in mid 2006.

- The inflationary consequences cannot be avoided as the intervention is not sterilized, i.e. the Royal Government of Cambodia cannot issue government bonds or Treasury Bills to absorb the excess of Cambodian Riel injected into the market, while purchasing US dollars.

- If the NBC do not intervene, the capital inflows can cause the exchange rate of the Cambodian Riel to appreciate, thus putting Cambodia's competitiveness at risk, especially for the non-tradable sector.

- Capital flows have financed a temporary boom in consumption, especially the real estate sector, which will eventually lead to a cut back in consumption and investment, once the flows will be reversed.

2.2. Demand-pull inflation

Demand-pull inflation is inflation caused by increases in aggregate demand due to increased private and government spending. A surge in the demand for goods and services in general (aggregate demand) is thought to "pull" prices up across the board, especially when aggregate supply is held back by capacity limitations. A major part of demand-pull theory centers on the supply of money: inflation may be caused by an increase in the quantity of money in circulation relative to the ability of the economy to supply (its potential output);

The above graph shows that there is correlation between the growth in money supply and inflation. To emphasize this thesis, Milton Friedman states that ***"Inflation is always and everywhere a monetary phenomenon".*** This is called demand-pulled inflation.

The critical issue, however, is to determine how much inflation is caused by the increase in money supply and how much is driven by the costs, i.e. increase in energy and food prices.

The above graph shows steep rise in liquidity or M2 money supply during the last five years. In response to demand-pulled inflation, the National Bank of Cambodia has taken the following monetary measures:

- Conduct prudent and tight monetary policy in order to curb inflation;
- Pursue the exchange rate policy of managed float, aimed at maintaining stable exchange rate, strengthening public confidence and sustaining the purchasing power of Riels. To avoid exchange rate volatility and market turbulence, the National Bank of Cambodia will strive to maintain appropriate level of local currency in circulation and continue to sell US dollars to EDC;
- Increase reserve requirements of commercial banks from 8% to 16% in order to absorb liquidity from the economy, especially to tighten lending bank loans to the private sector, following sharp increase in the credit to the private sector;
- Allow some financially sound banks with excess of liquidity to invest some of their assets abroad;
- (By an NBC Prakas dated 19 September 2008) increase the minimum capital from SO billion riel ($13 million) to 150 billion riels ($36.5 million) for commercial banks, unless they have an influential shareholder that is a bank or financial institution with an investment grade rating from a reputable rating agency; and increase minimum capital to 30 billion riels ($7.3 million) for a specialized bank;
- Conduct prudent, gradual policy aimed at promoting de-dollarization.

23. Cost-push inflation or "supply shock inflation"

Cost-push inflation is caused by drops in aggregate supply due to increased prices of inputs. The "cost-push" factors like oil, food, monopoly profit-taking, or wages would increase the general level of prices.

Producers who incur higher input costs could then pass this on to consumers in the form of increased output prices.

Inflation in Cambodia starts to rise commensurately with the increase in oil prices. Inflation was zero in 2002, rising to 1.15% in 2003 and 3.9% in 2004. Oil prices on the international market started to increase in 2003. Thus, one can reasonably say that inflation in Cambodia followed the oil price.

As oil prices accelerate in the second half of 2007, inflation reached 10.8% in December 2007. Higher food prices, which also accelerated in early 2008, pushed inflation further upward.

Trends in Monthly Exchange Rate

The acceleration in inflation in large part reflects the impact of higher energy and commodity prices. High inflation and in particular an increase in food prices must be taken seriously, as it creates

potentially significant challenges to socio-economic stability that could undermine prospects for restoring the combination of solid growth and low inflation that Cambodia has enjoyed in the past years.

World Price for Selected Food Commodities

Fiscal Policy Responses to cost-pushed inflation: Implemented Fiscal Policy Measures:

- Provide subsidies on petroleum imports by using administrative prices (2001 base price) to calculate tax liabilities (Oil subsidies: $170 million in 2007 and $250 million in 2008);
- Provide temporary and short-term subsidies to EDC to maintain electricity tariffs at the same level (Subsidies to power generation around $30 million);
- The 2008 Budget will be implemented within the limit of the Budget Law;
- In 2008, base salary has been increased by 20% for government officials, armed forces and retirees;
- The spouses and children's allowances of the government officials, armed forces, retirees, and disabled officials and soldiers have been increased by 100%, while the teacher allowances increased by 10% from April 2008.
- Increase living allowances by 20,000 Riels per month from August to December 2008 for government officials and armed forces;
- The government has instructed all ministries and public institutions to save fuel and electricity. In 2008, the use of petrol for administrative purposes is limited to the allocated amount stated in the Budget Law;

- Through the Rural Development Bank, the government provides special financing in the form of working capital to private rice millers to purchase rice for domestic processing. This loan, started in 2005, reached 10 million USD in 2008;

- The government has reintroduced the imports of food products, especially pork which was previously banned due to health concerns.

- Temporarily suspend for 3 years the 1% minimum profit tax for garment factories in order to improve company's cash flows, thus allowing garment factories to increase minimum wage by USD6 from the current of USD50 per month;

- Reduce customs tariffs and taxes on imports for the agriculture inputs. The measures will be linked to the increase in taxes on luxury goods such as cars, phones, televisions, Hi Fi audio equipments, air-conditions, VCR, VCP, alcohol, cosmetics and the other unnecessary products;

- Introduce temporary VAT exemption on agricultural products to improve food security and encourage processing of agricultural products to supply into domestic market;

- Introduce and then lift the ban on exports of paddy and rice for 2 months and instructed the Green Trade Co. and Cambodian Rice Miller Association to sell rice from their stock;

Although the above measures are mostly expansionary, the government has also taken contractionary measures to curb inflation:

- Limit spending, especially increase current budget surplus and reduce overall budget deficit;

- Increase government deposits in the banking system.

2.4. Built-in Inflation

Built-in inflation is induced by adaptive expectations, often linked to the "price/wage spiral" because it involves workers trying to raise their wages to keep up with higher prices (gross wages have to increase above the CPI rate to net to CPI after-tax) and employers passing higher costs on to consumers as higher prices as part of a vicious circle. Built-in inflation reflects events in the past, and so might be seen as hangover inflation.

The objectives of the Government's introduced policy measures is to return the Cambodia economy to a path of strong and stable growth, accompanied by low and stable inflation.

To achieve this objective in the current circumstances will require a coherent set of policy responses across a broad front. These will include structural measures designed to improve market efficiency, as well as possible monetary and fiscal policy adjustments. The challenges are great and the responsibilities in this effort inevitably will have to be shared among all concerned stakeholders. Government policies will need to be adjusted to the situation of constant price increase. Broader measures as a basis to sustaining Cambodia economic growth and prosperity will include the followings:

1) Adoption of the policies to foster investment in the oil sector and in energy resources more generally and to ensure that investment regimes are stable and predictable, encourage greater cooperation and synergies between national and international concerned agencies through well-designed partnerships;

2) Public awareness campaign, educational programme and policies to increase conservation and energy efficiency that would help to moderate the growth in energy demand;

3) Continue to focus on improving of agricultural policies, which aim to upgrade infrastructure, distribution, and storage systems, expand irrigation systems, and look at feasibility to redirect subsidies toward high-yield products and key agricultural inputs such as fertilizer;

4) New fiscal measures will focus on monitoring, controlling and if needed stabilizing key Cambodia's economic sectors that are important to minimize downside risks to growth, such as the real-estate sector and the financial system;

5) Macroeconomic policies will be further tightened in response to generalized inflation pressures.

2.5. Additional Measures

It is important to keep in mind that rising prices and inflation are challenges to economic prosperity and progress, which are potentially serious, and the Government policy responses need to be appropriate, structurally coherent and consistent in order to mitigate the impact of fuel and food prices on overall inflation and on the Cambodia macroeconomic outlook in general. Therefore additional measures have been considered as follows:

- Strictly maintain the budget within the framework of the 2008 Budget Law and continue the policy of nonbank financing;

- In case of increase in necessary spending, limit current budget surplus to 2.5% of GDP;

- Maintaining the overall fiscal deficit at around 1% of GDP in 2008 and 2009 to contain inflation expectations;

- Increase government deposits in the banking system;

- In the case of revenue shortfalls, the Ministry of Economy and Finance will propose new saving measures or reduce the current allocations, by focusing on cutting non-priority expenditures;

- Strengthen the enforcement of property tax and unused land tax, including the implementation of the capital gain tax;

- Continue to implement public investment expenditures related to physical infrastructure such as roads, irrigation system and other expenditures, which aim at reducing economic costs and improving production and economic productivity along with the expenditure on education and health in the framework of the 2008 Budget Law;

- All government agencies are required to propose new savings measures and to mobilize revenue collection from all possible sources;

- Reduce new recruited government staff by 10% for 2009, from 9408 to 8259 officials.

Possible measures are as follows:

- Overall budget deficit (including grants) in 2008 should be at 1% of GDP;

- Increase excise on liquor and luxury goods in 2008 (broadening tax base and increase tax rates);

- Using actual import transaction prices for assessing taxation, including for alcohol, cigarettes and petroleum;

- Introduce VAT for electricity and water;

- Further strengthen land transaction tax collection;

- Introducing a property tax initially in major urban areas;

- Increasing excise rates, especially on beer and cigarettes;

- Replacing current tax incentives with investment allowances, tax credits, and accelerated depreciation.

2.6. Opportunities for Agricultural Development

Higher food prices present also opportunities for ASEAN economies to increase investment in agriculture in order to boost productivity and exports. The economic strategy of the Royal Government of Cambodia for the fourth legislature gives priorities to the following sectors:

1. Agriculture, which Cambodia has big potentials, due to the endowment of land and climatic conditions;

2. Physical infrastructure, especially transportation and telecommunications;

3. Electrical power and water supply;

4. Human resource development;

5. Labor-intensive and export industries;

6. Tourism, which Cambodia also has great potentials, notably with the presence of historical and cultural heritages, tradition and natural sites, such as forests, lakes, sea and attractive scenery.

Cambodia will further pursue our vision of building a society which enjoys peace, political stability, security and social order, and sustainable and equitable development, with strict adherence to the principles of liberal multi-party democracy, respect for human rights and dignity, and a society in which social fabric will be strengthened to ensure that the Cambodian people are well-educated, culturally advanced, and that can enable the Cambodian people to reclaim its glory in the international arena.

III. Indirect Impact of the Global Financial Crisis

3.1. The Causes of the Crisis

The financial crisis started in August 2007 as a subprime crisis, which took place against the backdrop of global financial imbalances and in the context of liberalization of world financial markets. The subprime market, which experienced rapid growth during the last few years in the United States, accounted for no more than US$1,000 billion, compared with stock market capitalization of US$20,000 billion or the wealth of the American family of US$60,000 billion.

The following are the factors leading to the subprime crisis:

- ***Excess of liquidity at the global level and financial deepening*** (money supply divided by GDP of the six industrialized countries, United States, Euro zone, Japan, China, United Kingdom and Canada) increased from 20% in 1980-1970 to 30% in 2006-2007; rapid increase of the foreign exchange reserves of emerging countries and credit expansion (growth, decrease in real interest rate and financial innovation);

- ***Global decrease in inflation and its volatility;***

- ***Generalized decline in risk premium as a result of reduction in risk aversion.*** Huge liquidity led economic actors to seek high risk assets for placement and the search for high return. By contrast, since August 2007, aversion to risk has drastically increased;

- ***Decline in the long term interest*** rate – the drop in inflation and its volatility, coupled with the reduction in risk premium, led to the reduction in long-term interest rate, despite the contractionary (quite late) of the US monetary policy;

- ***Credit expansion in the context of low inflation*** – the drop in interest rate and risk premium created conditions for plentiful and cheap credit. Low inflation growth has continued, despite the increase in the prices of raw materials (oil, metal and basic food) as a result of the increase in demand in emerging countries. The decline in interest rates and risk premium provided also favorable conditions for high leverage operations – the increase in debt leverage of commercial banks hedge funds and private equity funds.

- *Increase in the prices of assets* – while excess of liquidity did not have incidence on the prices of goods and services, it had big impact on the price of assets against the backdrop of limited offer. The increase in the price of assets provided favorable conditions for the expansion in mortgage loans. The increase in the assets price and in the wealth effects led to increase in consumption.

- *Microeconomic malfunctioning* – (i) The search for high return – investors recourse to the bond markets (flight to quality); (ii) commercial banks adopted a two-pronged strategy – increase the volume of activities, while relaxing conditions for granting loans and introducing innovation; and (ii) relaxing conditions for granting loans – the volume of subprime loans (granted to high risk borrowers) multiplied by 7, increasing from $94 billion in 2001 to $685 billion in 2006. Loans with variable interests also increased drastically at the expense of the fixed interest loans.

- *High risk financial practices* – one of the pillars of bank supervision is that the increase in credit volume should go hand in hand with the increase in bank capitalization, thus constraining commercial banks from granting loans. However, financial institutions have adopted the strategy of bypassing this regulation by introducing new vehicles of securitization.

3.2. The Developments of the Crisis

Mortgage lenders distributed subprime loans to low income households, who were not eligible for prime rate loans and were known for defaulting previously contracted credits. The households were not informed that the interest rates were variable or would increase after one or two years.

The mortgage lenders then resold the subprime loans to investment banks (in some cases the mortgage lenders and the investment banks are from the same group).

With financial innovation, financial engineers transformed the subprime loans, via securitization, into securities, such as Mortgage-Backed Securities (MBS) or (for non-mortgage loans) into Asset-Backed Securities (ABS), then into Collateralized Debt Obligations (CDOs). The CDO made from ABS or MBS were rated by the rating agencies (Moody or S&P) by differentiating their risk profiles.

Investment banks buy, for their own account or for the account of their clients, billions of CDOs from ABS, which yielded higher returns than the US Treasury Bills.

To hedge against the risk, the investment banks bought insurance from specialized insurance companies (credit enhancers) or bought special securities called Credit Default Swap (CDS), issued by other investment banks. CDS have become a market on its own right. However, here this kind of risks might be uninsurable. The risk can be insurable, when insurance companies collect small premium from a large pool of policyholders to meet future liabilities, when only a few claims will occur.

When interest rates started to increase from late 2006, more and more American households found out that their monthly payment were exploding. Unable to pay back the mortgage loans, they were evicted from their homes, which were then seized by banks that have sought to resell them later on. But when the number of foreclosures exploded, the real estate market collapsed.

Investors who bought CDO via Mutual Funds realized that parts of the mortgages based on which the securities were made would not be redeemed. Holders of CDO attempted to get rid of them and the CDO market also collapsed. The credit enhancers who supposed to guarantee the value of the securities are unable to meet the claims and went bankrupt. The investment banks had to depreciate the value of CDOs that they hold on their books.

Each bank knows the value of "toxic" CDOs they hold on their books, but ignore how much their neighbors have. By precaution, they refuse to lend money to other banks, except in case of high interest rate. Banks that rely on the inter-bank market for refinancing have become fragile. The market has become such very complex and opaque that bankruptcy of a financial institution will impact another bank through the domino effect. The banks need some time to understand and evaluate their exact exposure to these "toxic securities". Therefore, the bankruptcy of a bank sent a ripple effect to other banks that were involved with the troubled banks.

3.2. Impact of the Global Financial Crisis on the Cambodian Economy

The current global financial crisis has had only indirect impact on the Cambodian economy. Cambodia's commercial banks do not have direct exposure to the subprimes. The indirect impact will be at the following levels:

3.2.1. Indirect Impact on Banks

The current global financial crisis will have only limited indirect impact, if any, on Cambodian banks. The National Bank of Cambodia only recently authorized financially sound commercial banks with excess of liquidity to invest some of their assets abroad. The foreign assets of the banking system are invested abroad by the NBC in very secured financial instruments. Therefore, the exposure to the crisis only via the parent companies of some commercial banks based in Cambodia. So far there is no information that any of them have been affected by the subprime crisis.

Lending is based on collateral linked to real estate. Cambodia is still a cash-based economy. The real estate market has slow downed, but there is no sign of hard landing. The measures to improve the banking system include:

- Limit commercial bank's exposure to some high risk sectors, especially the real-estate sector, by introducing a 15% ceiling for loans to real estate trading;

- (By an NBC Prakas dated 19 September 2008) increase the minimum capital from 50 billion riel ($13 million) to 150 billion riels ($36.5 million) for commercial banks, unless they have an influential shareholder that is a bank or financial institution with an investment grade rating from a reputable rating agency; and increase minimum capital to 30 billion riels ($7.3 million) for a specialized bank;

Future Monetary Measures include:

- Improve classification of loans in order to improve supervision and limit exposure to the risky sectors, especially loans exceeding USD100,000;
- Improve the valuation of collateral of bank lending;
- Strengthen further the banking system through rigorous implementation of on-site and off-site inspections and supervision;
- Strengthen bank credit information system;
- Strengthen the system for implementing reserve requirements.
- Draft Prakas on internal auditing;
- Draft Prakas on external auditing;
- Draft Prakas on Corporate Governance of Bank and Financial Institutions;
- Draft Prakas on Classification of Provisions of Assets held by Banks and Financial Institutions;

The above measures that have been taken or future measures to be taken by the NBC will further strengthen the soundness of Cambodia's banking system.

3.2.2. Indirect Impact on Garment Exports

Financial crisis would lead to lower consumption. The impact depends on to what extent the financial crisis will affect the real economy and how long will recession last. People therefore prefer to save money to meet difficult time ahead. The drop in consumption would further lead the economy into an economic crisis. Cambodia exports around 70% of garment products to the US. During the crisis there will be a substitution effect, shifting from the purchase of luxury goods to the mass consumption goods like Cambodian garments. As both the US and Europe are in recession, the chance is that the level of garment exports will be leveled off in 2008, compared to last year.

3.2.3. Indirect Impact on Tourism

People would prefer to put off their holidays during hard times. Job losses and morose environment would be less favorable for vacations. Tourist arrivals in 2008 would grow, albeit at a slower pace compared to last year.

3.2.1. Indirect Impact on Construction

The real estate market in Cambodia is stagnant since June 2008. The central bank policy to limit exposure to the real estate market managed to cool down the market and prevent the bubbles from bursting. Moreover, investors are cautious, as real estate crisis is in full swing in the US and in Vietnam. There is no sign of commercial banks exposure to the real estate problems.

Garment, tourism and construction constitute 3 of the four pillars of Cambodia economic growth. Sluggish growth of the three subsectors would result in lower economic growth, estimated at 7% in 2008 and 6.5% in 2009.