CAMBODIA ECONOMIC UPDATE

DECEMBER 2022

NAVIGATING GLOBAL ECONOMIC HEADWINDS

SPECIAL FOCUS

POVERTY AND DISTRIBUTIONAL IMPACT OF INFLATION IN CAMBODIA

WORLD BANK GROUP

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ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
CCFTA	Cambodia-China Free Trade Agreement
CEU	Cambodia Economic Update
CKFTA	Cambodia-Republic of Korea Free Trade Agreement
COVID-19	coronavirus disease 2019
CPI	Consumer Price Index
CR	Cambodian riel
CSES	Cambodia Socio-economic survey
DPs	development partners
DSA	debt sustainability analysis
EAP	East Asia and Pacific region
EMDEs	emerging market and developing economies
EU	European Union
FCDs	foreign currency deposits
FDI	foreign direct investment
FED	U.S. Federal Reserves
FTA	free trade agreement
GDP	gross domestic product
GSP	Generalized System of Preferences
GTF	garment, travel goods, and footwear
IFAD	International Fund for Agricultural Development
MFI	Microfinance Institution
NBC	National Bank of Cambodia
NPL	nonperforming loan
PMI	Purchasing Managers' Index
QIP	Qualified Investment Project
RCEP	Regional Comprehensive Economic Partnership
SDR	special drawing right
U.S.	United States
US$	United States dollar
VAT	value-added tax
YTD	year to date
y/y	year on year

Part 1

Recent Economic Developments and Outlook

PART 1: RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

EXECUTIVE SUMMARY

Recent developments

While recovering from COVID-19, Cambodia's economy is now facing global economic headwinds. Real growth has strengthened, underpinned by an increasingly broad-based economic recovery. Since the second quarter of 2022, the recovery has gained momentum on the back of continued resilient garment, travel goods, and footwear exports. The services sector, especially the travel and tourism industries, has also improved as the strategy of "living with COVID-19" introduced late last year paid off. Total international arrivals steadily improved, reaching 1.2 million during the first 9 months of 2022. Reflecting growing investor confidence, investment, including FDI, has also picked up. However, Cambodia's small, open economy is now confronting global economic headwinds as world trade growth started to slow in the second half of 2022 amid a gloomy and uncertain global outlook.

The current account improved in the first half of 2022 as the trade deficit narrowed. Cambodia's goods export growth accelerated, surpassing its pre-pandemic growth rate. In the first 8 months of 2022, merchandise exports surged, growing at 28.6 percent y/y, driven largely by exports of main manufacturing products, namely garment, travel goods, and footwear, which grew at 30.3 percent y/y. Merchandise imports growth eased, increasing 18.3 percent y/y. This led to a temporary improvement in the trade balance. However, Cambodia's terms of trade have worsened since the second quarter of 2022, with the impact of higher oil prices partially offsetting the deceleration in import growth. Overall, Cambodia's current account recorded an estimated deficit of 11.2 percent of GDP in the first half of 2022.

Rising global energy, fertilizer and food prices prompted a surge in inflation. Consumer price inflation accelerated to 7.8 percent in June but eased to 4.9 percent in August 2022. The relatively high weight of the transport component of 12 percent of the country's Consumer Price Index consumption basket exacerbates these negative impacts. The oil and food price shock has also started to affect agricultural production, as the prices of fertilizer and pesticide have increased.

Rising inflation is particularly harmful to poor households. As discussed in the Special Focus section below, faced with a budget constraint, higher prices can lead the poor to reduce consumption and to change their consumption to less expensive and lower-quality goods. Higher prices may also lead the poor to withdraw children from school. As a consequence, inadequate spending on nutritious food, and withdrawal of children from schooling, can have detrimental long-term effects on human capital, causing losses in worker productivity and welfare, and disparities in income in the future.

To mitigate impacts of the food and oil price shock, the authorities are planning to introduce additional social assistance measures, while extending the existing COVID-19 cash transfer program until end-2022. The program benefits approximately 706,060 households (2.8 million individuals) or 17 percent of the population. As of October 2022, the program had disbursed US$837.05 million (about 2.7 percent of GDP) after its launch in June 2020. Since the third quarter of 2022, there have been no (reported) COVID-19-related deaths, and the daily infection cases remained contained at single digits, reflecting the country's success in rolling out its vaccination program. By end-October 2022, about 88.0 percent of the population had received two doses of the COVID-19 vaccine and 61.4 percent had received booster doses.

Monetary policy continued to be accommodative, underpinning the economic recovery. Broad money growth eased slightly to 12.0 percent y/y in August 2022, down from 16.1 percent during the same period last year as foreign currency deposit growth slowed. Private sector deposit growth, however, remained robust at 14.2 percent as confidence in the banking system continued. Reflecting a solid demand for credit to finance the economic recovery, domestic credit growth was strong, increasing by 22.7 percent. Despite increased pressures caused by persistent external imbalances and appreciation of the U.S. dollar, the exchange rate continued to be broadly stable. The exchange rate was 4,150 riel per U.S. dollar in October 2022, compared to 4,074 riel per U.S. dollar during the same period last year. Gross international reserves, however, marginally declined to US$18.4 billion (8-month import coverage) in August 2022, down from US$20.2 billion in December 2021.

The economic recovery and continued improvements in revenue administration underpinned across-the-board revenue growth. Domestic revenue growth has now fully recovered. During the first 8 months of 2022, central government revenue collection, which accounts for 92.1 percent of total domestic revenue, increased by 23.8 percent y/y, outpacing nominal GDP growth. After accelerating last year to meet rising pandemic-related spending demand, budget expenditure is expected to decelerate this year. During the first 8 months of 2022, central government expenditure recorded an 8.4 percent y/y decline as capital expenditure slowed. Fiscal revenue, including grants, is projected to improve, reaching 22.8 percent of GDP. Expenditure is expected to decline to 27.4 percent of GDP. The fiscal deficit is, therefore, projected to narrow, but remains relatively large at 4.6 percent of GDP. The deficit will continue to be largely financed by external borrowing, covering about 90 percent of the financing requirements, while the rest is to be financed by a drawdown of government deposits (fiscal reserves), which stood at 17.1 percent of GDP by August 2022. Cambodia's public debt-to-GDP ratio reached 32.3 percent by mid-2022.

Outlook

Cambodia's real GDP growth projection has been revised up to 4.8 percent in 2022 on the back of a more broad-based economic recovery (see table ES1). The surge in manufacturing exports—especially garment, footwear, travel goods, and bicycle manufacturing; the revival of the travel and tourism industries; and the return of FDI inflows have helped sustain this year's economic recovery. Even though the economy is expected to further expand next year, supported by a recovery of domestic consumption as employment rates improve and inflation recedes, along with strong government consumption during an election year, real growth projection for 2023 has been downgraded to 5.2 percent due to the less favorable global outlook.

Table ES1: Projections

				Change from June 2022		
	2022	2023	2024	2022	2023	2024
Real growth (%)	4.8	5.2	6.3	0.3	-0.6	-0.3
Inflation (%)	6.0	4.2	3.8	-1.2	-0.3	-0.2
Current account (% of GDP)	-25.0	-15.6	-12.6	-0.3	3.0	2.3
Fiscal balance (% of GDP)	-4.6	-5.3	-3.5	2.0	0.9	1.1

In the short term, the fiscal balance is projected to continue to normalize on the back of stronger growth and better revenue administration. This is expected to result in buoyant revenue performance, while expenditure is expected to ease with the decline in demand for COVID-19 related spending. Inflation is expected to decelerate to 4.2 percent and 3.8 percent in 2023 and 2024, respectively. The external account sees further improvement through relatively resilient exports. Poverty is expected to decline due to the projected economic recovery and moderate inflation.

Over the medium term, the economy is expected to trend back to potential, growing at around 6 percent. The tourism and hospitality industries are likely to accelerate further, with projected increases in international arrivals and domestic tourists once the pandemic is behind us. Agricultural production and agroprocessing industries continue to be boosted by newly ratified free trade agreements. In addition to the Cambodia-China Free Trade Agreement (CCFTA) and the Regional Comprehensive Economic Partnership (RCEP), which have been in effect since January 2022, the Cambodia-Republic of Korea Free Trade Agreement (CKFTA) will go into effect in December 2022. The travel, transport, and logistics industry should be boosted by strong investment in several key infrastructure projects, such as a newly built expressway linking Phnom Penh to Sihanoukville, where a deep-sea port is located; a new logistics complex and multimodal port development project in Kampot; and a new expressway project linking Phnom Penh to Bavet, on the Cambodia-Vietnam border.

Challenges and risks

Although the near-term growth outlook has improved marginally since April, risks are tilted to the downside. Global trade growth is projected to slow sharply in 2023 as the global economy faces strong headwinds. According to the World Trade Organization, world merchandise trade volume is expected to slow sharply to 1.0 percent in 2023, down from 3.5 percent in 2022. The dangers of inflation, slow growth, lower productivity, the drain on global energy supplies, and higher interest rates are impacting developing countries. Cambodia's export-oriented manufacturing is vulnerable to an extended slowdown in the United States, Cambodia's largest export market. Similarly, the slowdown in China, Cambodia's largest source of foreign direct investment, if sustained, will negatively impact investment and capital inflows into the country. The European Union, Cambodia's second largest export market, is facing significant downward risks amid high energy prices and inflation.

Global financial tightening has started to negatively impact the economy. Cambodia has been experiencing a deceleration of foreign currency deposit growth, reflecting the easing of capital inflows. There have been depreciation pressures on the riel/U.S. dollar exchange rate, which required interventions in the foreign exchange market and led to the decline in Cambodia's gross international reserves. As pressures on domestic interest rates emerged, the country's commercial real estate sector faced increased risks.

If elevated energy prices linger, a further deterioration of the terms of trade will undermine consumer confidence and corporate profitability, and potentially prevent the economy from reaching potential growth by 2024. Further, intensifying geopolitical tensions, including a prolonged war in Ukraine, growing stagflationary headwinds, rising financial instability, continuing supply-side constraints, and worsening food insecurity all present serious risks to Cambodia's projected path to economic recovery. Even though Cambodia maintains policy space that it could deploy should these risks materialize, its fiscal buffers have shrunk, after years of government fiscal intervention.

Policy options

With the recovery from COVID-19 still underway, Cambodia must now navigate through global economic headwinds. While demand for social assistance spending continues, the fiscal space has shrunk. To mitigate impacts of the oil and food price shock, the authorities are planning to introduce additional social assistance measures on top of the existing COVID-19 cash transfer program. Cambodia entered the pandemic with ample fiscal buffers, but the economic contraction in 2020 combined with large (and protracted) spending on health and social assistance led to a substantial increase in the fiscal deficit and the debt level. Once the recovery becomes more entrenched, policies will need to shift towards consolidation to ensure fiscal sustainability and regain fiscal space. In this context, it is important to start broadening the tax base by introducing a personal income tax. Due mainly to the absence of a personal income tax, Cambodia's direct revenue as a share of total domestic revenue remained relatively low at 25 percent in 2020, compared to 30.1 percent in Thailand and 36.6 percent in the Philippines.

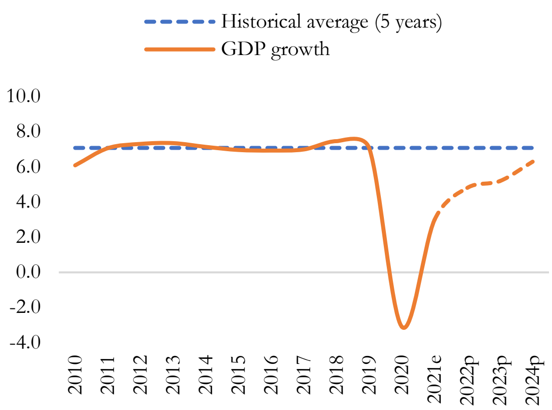
Safeguarding financial stability is crucially important. The country's commercial real estate sector faces increased risks as financial conditions tighten. It is crucial to closely monitor the current elevated credit growth, high levels of private debt, rising nonperformance loans, and the concentration of related risks in the construction and real estate sectors to ensure macrofinancial stability. To this end, it is important to safeguard the financial system with bank restructuring, corporate insolvency, deposit insurance, and debt restructuring regulations. There is a need to rein in the high credit growth and the concentration of credit in the real estate sector. Disruptions in the commercial real estate market could in turn potentially threaten financial stability through the connectedness of the sector with the financial system and the broader macroeconomy. Continued vigilance is warranted on the part of financial supervisors to mitigate such risks. In addition, negative impacts of global financial tightening point to the importance of ongoing dedollarization efforts.

Promoting the domestic economic sectors, focusing on the travel, tourism, and hospitality industries should help partly offset the deterioration of external demand conditions. In this regard, Cambodia must address key issues as indicated in the 2021 World Economic Forum's Tourism and Travel Development Index, in which Cambodia was ranked 79th, compared to 52nd for Vietnam and 36th for Thailand. Those issues include tourism service infrastructure, port infrastructure, environmental sustainability, and business environment. Despite a rapid expansion of the road network during the last several years, the country continues to exhibit insufficient connectivity to secondary destinations and last-mile road networks. There are several issues related to quality of services such as management (and provision) of waste and wastewater, piped clean water supply, and access to reliable electricity that need to be addressed. Those issues can only be resolved with improved destination-level management. And successful facilitation of coherent private sector leadership of the sector should help create a "crowding-in" effect, anchored to comprehensive long-term plans, catalyzed by public seed funding.

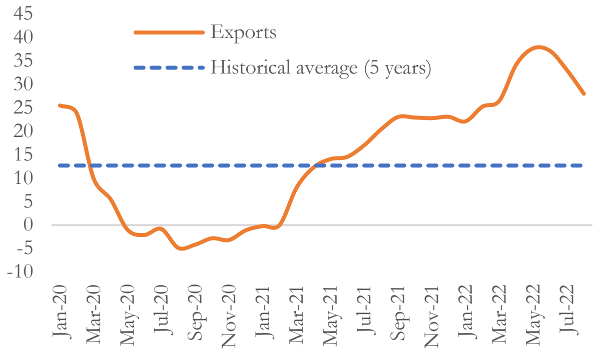
It is equally important to address supply chain constraints, which include high logistics and transportation costs to boost exports. The national logistics costs in Cambodia, estimated at 26.4 percent of GDP in 2020, are significantly higher than in comparable Association of Southeast Asian Nation (ASEAN) countries such as Indonesia (22 percent of GDP), Vietnam (20 percent of GDP), and Thailand (14.1 percent of GDP). To this end, it is necessary to address the high inventory costs in Cambodia by promoting access to finance and inventory management capabilities, while reducing transport costs by further facilitating trade. It is also essential to continue addressing supply-side bottlenecks by reducing the cost of energy, doing business, and licensing, especially for the exports sector, to revive external competitiveness.

FIGURE ES.1. CAMBODIA'S RECENT DEVELOPMENTS AT A GLANCE

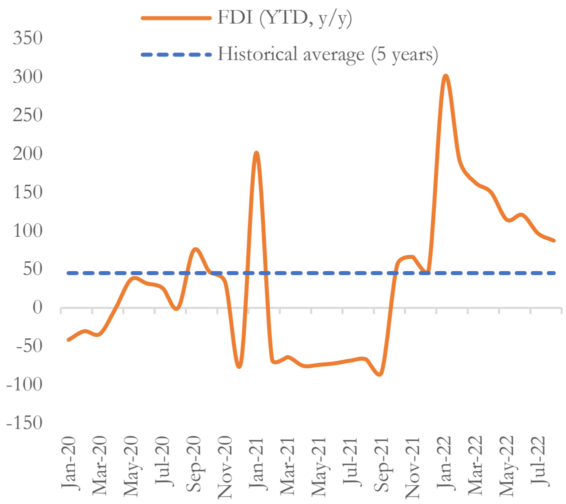
Real growth continues to gradually recover…
Real growth (percent)



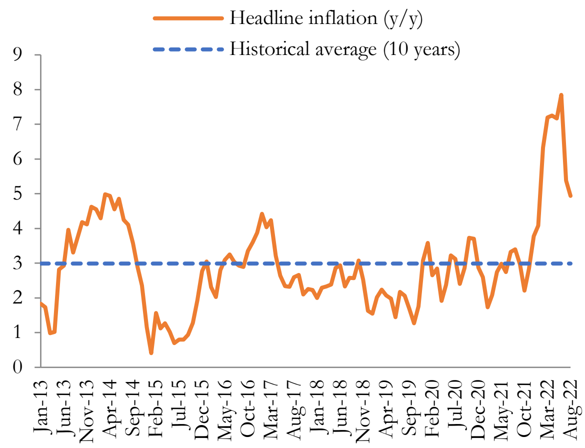
…Thanks to continued strong goods exports…
(YTD, y/y, percent change)



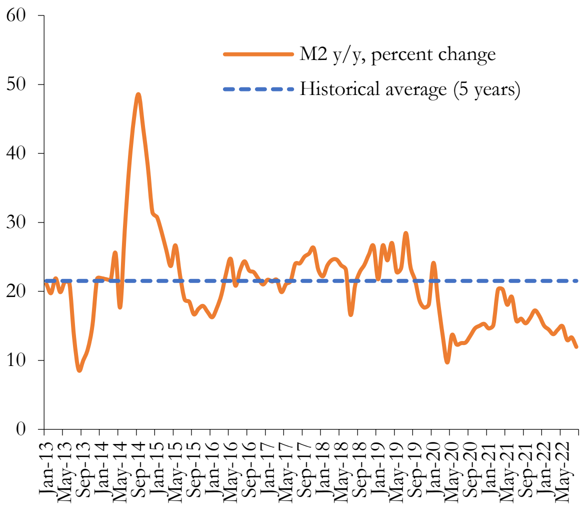
…While approved FDI value remained robust…
(YTD, y/y percent change)



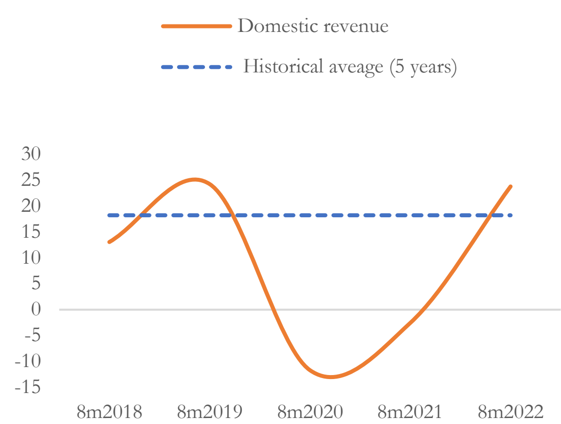
…But the oil price shock pushed up inflation…
(y/y percent change)



…Broad money (M2) growth eased, despite accommodative monetary policy…
Broad money liabilities (y/y percent change)



…Revenue growth recovered, narrowing the fiscal deficit
Central government domestic revenue
(y/y percent change)



Sources: Cambodian authorities; World Bank staff estimates and projections.
Note: e = estimates; p = projection; YTD = year to date; y/y = year on year.

Recent developments

Economic recovery amid looming global demand slowdown

Cambodia's economic recovery gained momentum (figure 1) on the back of continued resilient exports, a revival of the services sector, and a recovery of foreign direct investment (FDI) inflows. Since the second quarter of 2022, the traditional export-oriented industries—especially garment, travel goods, footwear, and bicycle manufacturing—have expanded further. The services sector, especially the travel and tourism industries, has also improved, with rising international arrival numbers. Investment, especially FDI in the tradeable sectors, has also accelerated. The country has experienced a broad-based economic recovery, after adopting a strategy of "living with COVID-19" in late 2021. Since late June 2022, new COVID-19 infections have been detected, caused primarily by the spread of the Omicron variant; however, infections remained contained at single-digit cases per day (figure 2). There were no reported COVID-19-related deaths since early this year, reflecting the country's success in rolling out its vaccination program. By end-October 2022, about 88.0 percent of the population had received two doses of the COVID-19 vaccine and 61.4 percent had received booster doses.[1]

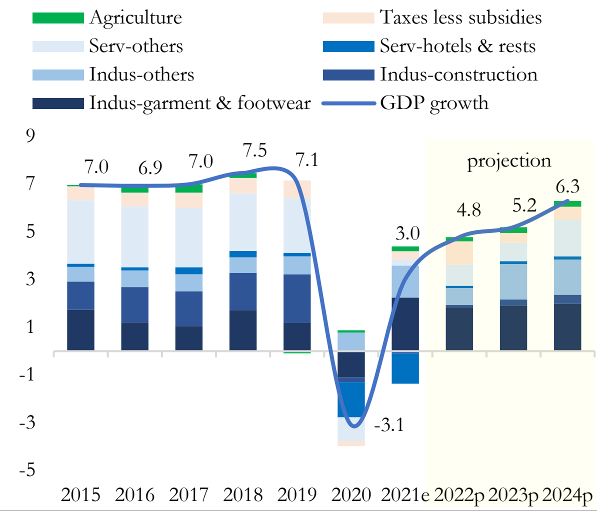
However, Cambodia's small, open economy is now facing global economic headwinds (see also box 1 for global economic developments and outlook). Cambodia's export-oriented manufacturing sector is vulnerable to an extended slowdown in the United States, Cambodia's largest export market. Similarly, the slowdown in China, Cambodia's largest source of FDI, is negatively impacting investment and capital inflows into the country. The European Union, the second largest export market for Cambodia, is also facing significant recession risks.[2]

Globally, financial conditions have tightened notably this year, leading to capital outflows from many emerging and frontier market economies with weaker macroeconomic fundamentals.[3] Amid heightened economic and geopolitical uncertainties, investors aggressively pulled back from risk taking in September. There is risk of a disorderly tightening of financial conditions that may be amplified by vulnerabilities built over the years.

While remaining strong, goods exports showed signs of easing

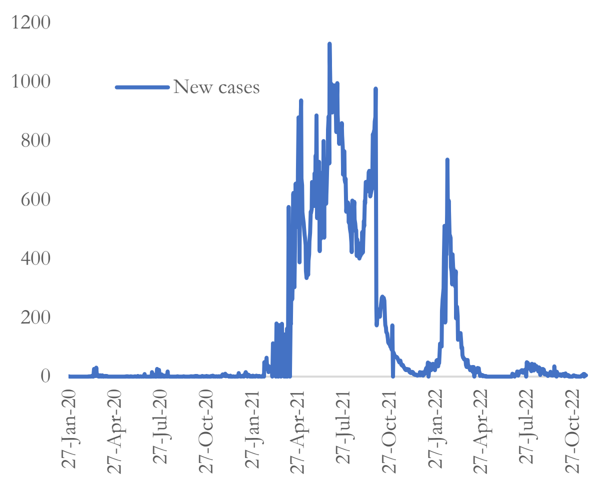
Goods (excluding gold) exports remained strong, underpinned by continued external demand. During the first eight months of 2022, goods exports grew at 28.0 percent y/y (figure 3). Manufacturing exports of the top three items—garment, travel goods (bags), and footwear (GTF)

Figure 1. Economic recovery continued
Contribution to real GDP growth
(percent)



Source: Cambodian authorities and World Bank staff projections.
Note: e = estimates; p = projections.

Figure 2. COVID-19 infections receded
(Daily new cases as of November 23, 2022)



Source: https://ourworldindata.org/coronavirus/country/cambodia.

[1] See https://ourworldindata.org/covid-vaccinations.
[2] Malpass 2022.
[3] International Monetary Fund 2022a.

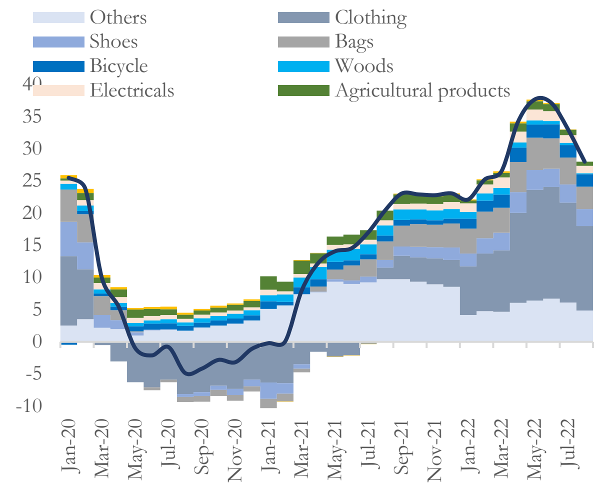
products—which account for 64.8 percent of total goods (excluding gold) exports, remained strong, reaching US$9.1 billion, a 30.3 percent y/y increase. Exports of non-GTF products, which mainly include bicycles, wood products and furniture, electrical/vehicle parts and cables, and agricultural commodities (rice, rubber, and banana), account for the remaining 35 percent, growing at 23.9 percent y/y during the same period. However, the growth rate of goods exports decelerated from its peak of 37.7 percent in May 2022, likely reflecting softening demand. According to the World Trade Organization (WTO), global trade has lost momentum in the second half of 2022 and will remain subdued in 2023 as multiple shocks weigh on the global economy.[4]

Goods exports to the United States, Cambodia's largest export market, accounting for 45.6 percent of total exports, continued to be strong. Goods exports to the United States reached US$6.4 billion, with a whopping y/y rise of 37.0 percent during the first 8 months of 2022 (figure 4), despite expiration of the U.S. Generalized System of Preferences program on December 31, 2020, reauthorization of which is pending U.S. congressional approval. Since 2020, the United States has been Cambodia's largest export market. The share of the U.S. market in total goods exports rose quickly to 45.6 percent in 2022, from 27.6 percent in 2019 at the expense of that of the European Union (EU) market, which declined to 19.8 percent from 28.1 percent during the same period, partly affected by the partial withdrawal of the EU's Everything But Arms preferential treatment, effective August 12, 2020 (impacting approximately 20 percent of Cambodia's exports to the EU).

In addition, Cambodia's exports to the United States are more diversified than those to the EU. For the U.S. market, while exports of GTF products continue to capture the largest share, they account for only 59.1 percent, compared to 80.9 percent in the EU market. The second, third, and fourth largest non-GFT export items destined for the U.S. market are wood products/furniture (5.2 percent), electrical/vehicle parts and cables (4.5 percent), and bicycles (3.8 percent), respectively. The shares of these higher value-added non-GTF products continued to be relatively small due to Cambodia's structural weaknesses, which include high logistics and energy costs, and a skills gap.

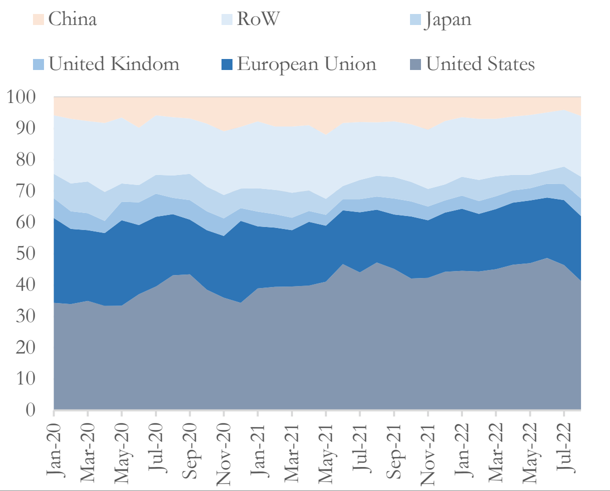
China is an increasingly important export destination for Cambodia's agricultural commodities, thanks to the Cambodia-China Free Trade Agreement (CCFTA), which went into effect on January 1, 2022. While the Chinese market accounts for US$805 million, or 6.0 percent of total goods exports, it captured 40 percent (US$281 million) of Cambodia's total agricultural commodity exports (US$715 million) during the first 8 months of 2022. For the Chinese market, bananas, milled rice, and cassava are the three largest agricultural commodity export items, accounting for 99 percent (US$140 million), 37.8 percent (US$94 million), and 75 percent (US$21 million), respectively (figure 5). Rubber exports to China remained relatively small, amounting to

Figure 3. Goods exports remained strong
Contribution to exports growth
(percentage points)



Source: Cambodian authorities.

Figure 4. The U.S. is the largest market for goods (excluding gold) exports
(% share)



Source: Cambodian authorities.
Note: RoW = rest of the world.

[4] World Trade Organization 2022.

US$13 million or 6.2 percent of total rubber exports. Under the CCFTA, over 90 percent of tariff lines of trade in goods[5] for both sides enjoy zero tariff, and the service market commitments also represent the highest levels among the two sides' agreements with their free trade partners. The CCFTA is expected to also attract more foreign investors, especially Chinese ones, to the country.

Strong investor appetite

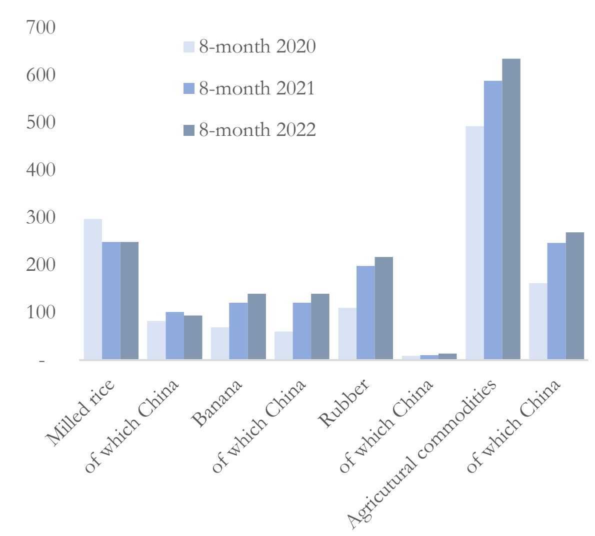
Approved FDI project value picked up. Approved Qualified Investment Project (QIP) value in the real sector accelerated and continued to be diversified. Approved QIP value reached US$4.0 billion, increasing by 260 percent y/y during the first 8 months of 2022, of which (approved) FDI accounted for US$1 billion, or an 87.4 percent y/y increase (figure 6). Chinese FDI accounted for about 90 percent of total approved FDI project value. Reflecting continued diversification, approved project investment value in the non-garment sector reached US$3.4 billion or 85.6 percent of total investment, up from US$778 million or 70.3 percent during the same period last year. The logistics and hospitality sectors received US$1.3 billion and US$129 million, respectively. Investment in the energy sector (hydropower plant) accounted for US$389.4 million. Other investment projects include building material, healthcare, auto assembly, solar panels, and electronics. Approved project investment value in the garment and agriculture sectors also rose to US$212 million and US$178 million, respectively, compared to US$139 million and US$61 million, respectively, during the same period last year.

Sluggish property development activity continued, but the occupancy rate improved

A partial recovery of the travel and tourism sector has improved economic prospects of tourism-related construction activity, despite continued sluggish property development activity. Staycations among domestic tourists continue to initially support the occupancy rate.[6] This helped stabilize and cushion sales prices and rents of affordable and midrange condominiums. The occupancy rate is recovering as the tourism sector and domestic economic activity continue to sustain a gradual recovery. Affordable hotels experienced a recovery as budget tourists and business travelers seem to have returned. Demand for centrally owned office supply stabilized, with an occupancy rate of 70 percent in the second quarter of 2022 as face-to-face interactions picked up. Retail supply improved, with an occupancy rate also of 70 percent.

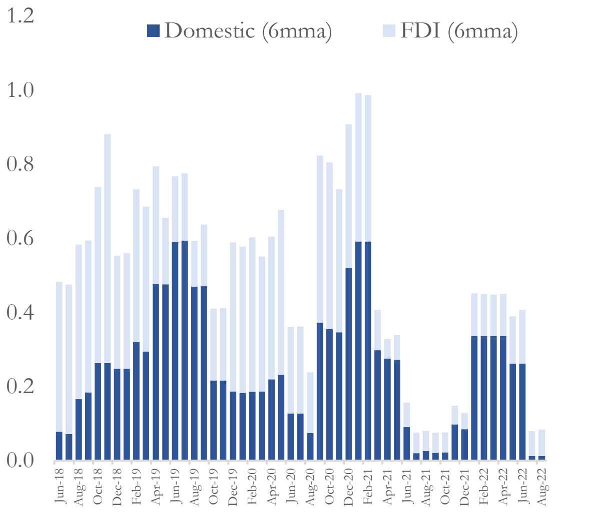
However, property development activity continues to suffer from excess supply, with reduced foreign investor appetite for investing in property development projects. Reflecting continued sluggish demand in the property and real

Figure 5. China is an important market for Cambodia's agricultural commodity exports
(US$ million)



Source: Cambodian authorities.

Figure 6. Investment appetite returned
Approved QIP value
(US$ billion, 6-month moving average, fixed asset)



Source: Cambodian authorities.

[5] Note the tariff for rice, corn, cane, unmanufactured tobacco, and natural rubber products are excluded under the CCFTA.

[6] Q3 2022.

Box 1. Global economic developments and outlook

After a strong initial recovery, global economic growth is expected to slow precipitously from 5.7 percent in 2021 to 2.9 percent in 2022.[a] Russia's invasion of Ukraine and its effects on commodity markets, supply chains, inflation, and financial conditions have steepened the slowdown in global growth. In advanced economies, where activity is being dampened by high energy prices and significant tightening of financial conditions, growth is projected to decelerate from 5.1 percent in 2021 to 2.6 percent in 2022. Growth in emerging market and developing economies (EMDEs) is projected to slow from 6.6 percent in 2021 to 3.4 percent in 2022.

Quarterly global output growth has slowed considerably since the beginning of this year. The global composite output Purchasing Managers' Index (PMI) fell into contraction territory in August 2022 (figure B1.1, panel A). Global goods trade has been particularly weak, reflecting softening demand for industrial goods across several large economies and continued trade disruptions associated with the war.[b] At 47.3, the global PMI Manufacturing New Export Orders Index remained in negative territory in August, recording the sixth straight month of contraction. Many EMDEs, particularly commodity importers, show signs of decelerating activity.

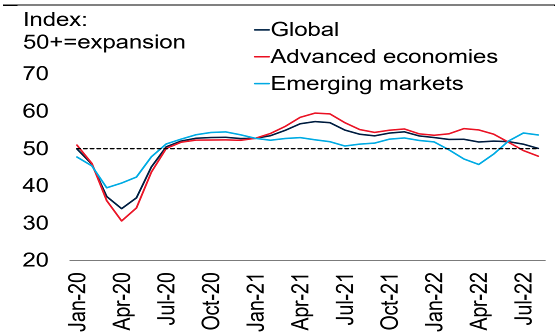
Global inflation has increased to multidecade highs. Inflation is above target in almost all countries that have adopted inflation targeting. Although some of the commodity prices have reverted to the pre-war level, inflation is persistent across regions and especially in advanced economies and Europe and Central Asia (figure B1.1, panel B). Higher food and energy prices, supply constraints in many sectors, and a rebalancing of pent-up demand have driven up headline inflation. But underlying core inflation has also increased, reflecting the pass-through of cost pressures through supply chains and tight labor markets, especially in advanced economies. In response, central banks are withdrawing monetary support and raising policy interest rates faster than previously expected. The resulting rise in borrowing costs and tighter global financial conditions have led to precipitous declines in equity prices, capital withdrawal from emerging markets, and currency depreciation against the U.S. dollar, inducing balance sheet valuation losses among economies with dollar-denominated debt.

Growth in the East Asia and Pacific region is projected to decelerate to 3.2 percent in 2022 as slower growth in China more than offsets a rebound in the rest of the region.[c] China's GDP is projected to grow by 2.8 percent in 2022, more slowly than the rest of the region for the first time since 1990. Growth in the rest of the region is projected to accelerate in 2022. The robust recovery of private consumption in the first half of 2022, the sustained demand for exports of manufactured goods and commodities, and the limited tightening so far of fiscal and monetary policy allowed strong growth of the region excluding China.

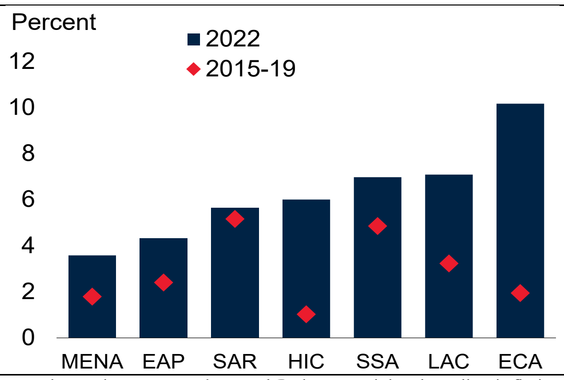
The current global environment is highly unfavorable for EMDEs. Global growth is slowing sharply, financial conditions are tightening, and inflation has soared in many countries. The world's three major engines of growth—the United States, the euro area, and China—are all expected to experience a protracted period of weakness. If persistently high inflation prompts even more monetary policy tightening in advanced economies, or if the dollar continues to strengthen, EMDEs are likely to face further tightening of global financial conditions, in parallel with a slowdown in global growth, and alongside continued shockwaves from the war in Ukraine, which together lead to the risk of severe financial stress in EMDEs.

Figure B.1.1. Global developments

Panel A. PMI composite output



Panel B. CPI Inflation



Note: a. Panel A shows seasonally adjusted composite output PMI, three-month moving average. b. Panel B shows weighted median inflation of each region in 2022 year to date as of August, compared to the average inflation during 2015–19.

Sources: Guénette, Kose, and Sugawara 2022; World Bank, Haver Analytics; S&P Global. a. World Bank 2022b. b. World Bank 2022. c. World Bank 2022a.
Note: This box was prepared by Ekaterine Vashakmadze.

estate market, approved construction permit value contracted by 54 percent (figure 7) during the first 8 months of 2022. Similarly, approved construction permit area contracted by 53 percent y/y. During the same period, the volume of total basic construction materials including cement, steel, and other construction material imports (in metric tons) mainly used for the construction industry contracted by 10.1 percent y/y (figure 8).

Prospects for the construction and real estate sector remain uncertain even after the pandemic ends. It is unlikely that construction will once again be a main engine of economic growth in the near future, despite a continued recovery of the travel and tourism industries (see more discussion on the tourism sector below). For several years preceding the crisis, Cambodia experienced an unprecedented construction and real estate boom, which created excess supply. External demand for the country's commercial and residential property partly contributed to the boom. Sihanoukville was one of Cambodia's urban centers that experienced the most rapid construction boom during the pre-pandemic period, with an influx of Chinese investment due to a prospect of a high investment return from tourism activities backed by a short-lived casino industry. The seaside provincial capital of Sihanoukville received US$5.8 billion of approved construction projects in 2019–20. The pandemic and then China's zero-COVID-19 policy continue to curtail construction and real estate activity.

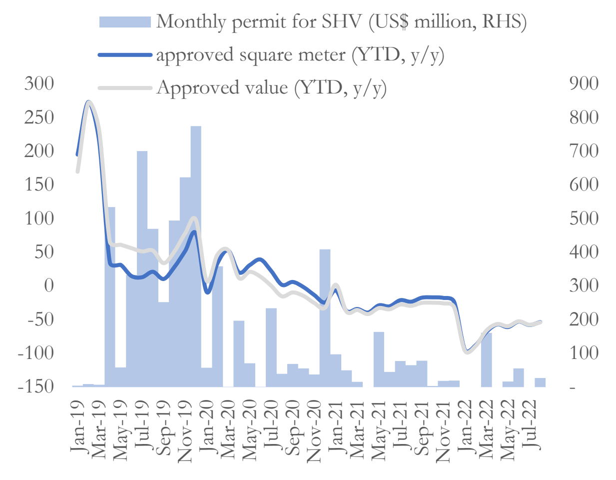
Recently, tourism-dependent cities such as Siem Reap and Sihanoukville have been steadily receiving more domestic and foreign tourists, while the ongoing large infrastructure projects mostly financed by public-private partnerships are being built to support the tourism industry. The new (US$2.0 billion) Phnom Penh-Sihanoukville Expressway and (US$20 million) Kampot International Tourism Port have been completed.

Tourism activity has gradually recovered

The travel and tourism industry, which was initially backed by a recovery of domestic travel and tourism, is now supported by increased international arrivals (figure 9). Arrivals have been facilitated by the reinstatement of the Visa on Arrival program, and removal in March 2022 of the requirement for a negative COVID-19 PCR test and, recently, for vaccination records, before arrival in Cambodia. Total international arrivals quickly improved, reaching 1.26 million during the first 9 months of 2022, although the number remained well below the 4.81 million visitors received during the same period in 2019. However, a recovery of foreign tourists visiting Siem Reap, the largest tourist attraction site in the country was relatively slow. Arrivals by air at Siem Reap accounted for a mere 5.5 percent (70,000 tourists) of the total, well below 29.1 percent (1.27 million tourists) received during the same period in 2019. Similarly, revenue from Angkor Wat entrance fees only marginally improved (figure 10), reaching US$5.3 million, compared to US$74.3 million during the same period in 2019.

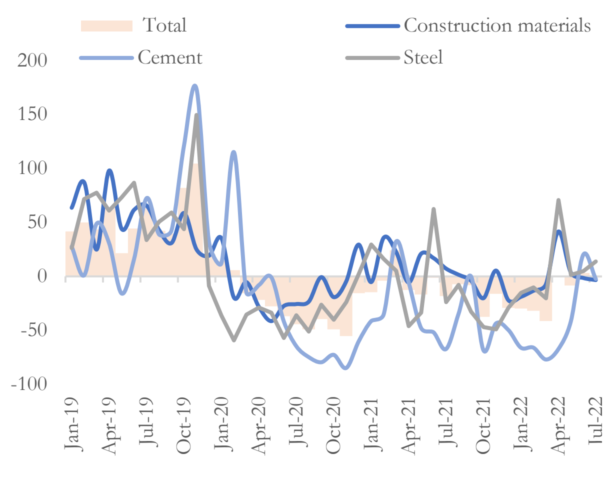
In addition, China's zero-COVID policy may affect the recovery of the tourism sector. During

Figure 7. **Approved construction permit value continued to contract**
(YTD, y/y percent change)



Source: Cambodian authorities.
Note: RHS = right-hand scale; SHV = Sihanoukville; YTD = year to date; y/y = year on year.

Figure 8. **Volume of construction material imports remained subdued**
(y/y, percent change)



Source: Cambodian authorities.
Note: y/y = year on year.

the pre-pandemic period, China was the largest source of foreign tourists visiting Cambodia. Chinese tourists accounted for more than a third (35.7 percent) of total international arrivals in 2019. During the first 9 months of 2022, the share of Chinese tourists in total arrivals plummeted, accounting for only 4.9 percent. Arrivals from Vietnam (36.0 percent) and Thailand (22.4 percent) ranked first and second, respectively. International arrivals by air accounted for 36.6 percent in the first 9 months of 2022, well below the 66.6 percent in 2019.

Efforts have been made to revitalize the tourism industry, with the introduction in October 2021 of the Siem Reap Tourism Development Masterplan 2021–2035 and completion in March 2022 of a US$150 million public investment project to develop the physical infrastructure, consisting of 38 roads with a total length of 108 kilometers (80 miles) in Siem Reap. However, Cambodia's tourism sector requires further improvements and investment. Insufficient connectivity, particularly the last-mile road network, especially to secondary destinations, has persisted for decades. Based on a previous study,[7] there were several issues related to quality of services such as management (and provision) of waste and wastewater, piped clean water supply, and access to reliable electricity that need to be addressed. Those issues can only be resolved with improved destination-level management, which includes strategic, organizational, and functioning decisions to manage the process of formulation, promotion, and commercialization of tourism products.

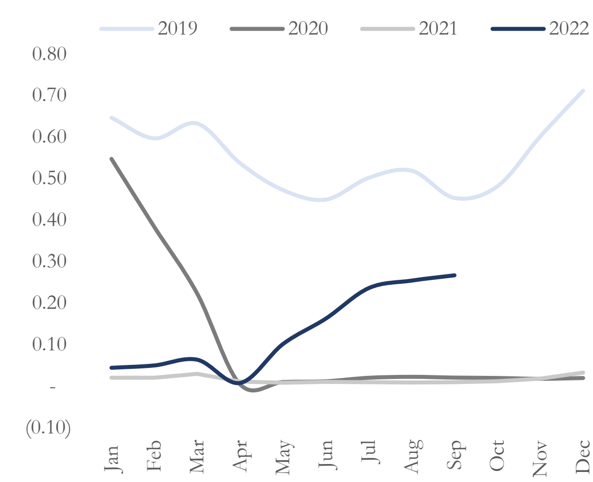
Floods may affect agricultural production, amid slow cultivation

Recent floods affected about 7 percent of rice crops in Cambodia's 22 provinces, especially Banteay Meanchey, Battambang, and Pursat. The authorities conducted an assessment of the damage caused by the floods in order to provide assistance such as seeds for replanting after the floods recede. The damage caused is compounded by the oil price shock, which has resulted in elevated prices of fuel, fertilizer, and pesticide. These negative impacts together with Cambodia's structural bottlenecks—high logistics and energy costs—do not bode well for this year's agricultural performance and exports.

As of July 2022, wet season rice cultivation was slow. It reached 2.2 million hectares, or an 11.8 percent y/y decline.[8] Harvesting of (short-duration varieties) wet season rice, however, accelerated, producing a total of 0.48 million metric tons, or a 20.7 percent y/y increase, with an average yield of 4.2 metric tons per hectare.

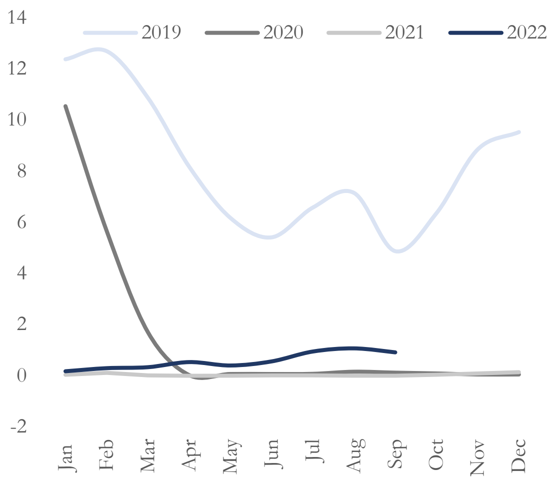
Non-rice agricultural production during the first seven months of 2022 was mixed, affected by price volatility. The major non-rice agricultural products are rubber and cassava, ranked second and third in terms of product value and exports, after rice. Rubber plantation covers 404,000

Figure 9. **International arrivals quickly recovered**
(in millions of visitors)



Source: Cambodian authorities.

Figure 10. **Angkor Wat entrance revenue slowed**
(US$ millions)



Source: Cambodian authorities.

[7] World Bank 2017.
[8] Monthly report on agriculture, forestry and fisheries for July 2022, Ministry of Agriculture, Forestry and Fisheries.

hectares, of which the harvesting area accounts for 310,000 hectares. In June 2022, rubber production was 30,000 metric tons, or a 2 percent y/y decline, affected by rubber price volatility, which fell to US$1,572 per metric tons or a 9 percent y/y decline. Rubber yield also shrank to 1,186 kilograms per hectare, down from 1,194 kilograms.

During the first nine months of 2022, milled rice exports reached 0.45 million metric tons or a 10 percent y/y increase, amounting to US$286 million, according to the Cambodia Rice Association. Two major export markets are China and France, capturing 44.1 percent and 14.8 percent of total milled rice exports, respectively. Premium aromatic, fragrant, and long-grain rice accounted for 39 percent, 29 percent, and 28 percent of total milled rice exports, respectively. During the same period, paddy rice exports reached 2.35 million metric tons, amounting to US$563 million.

During 2012–21, production of main crops, especially rubber and cassava, experienced high volatility (figure 11), reflecting continued heavy dependency on weather conditions (for rice and cassava) and on global prices (for rubber). The volatility does not bode well for the development of the domestic agroprocessing industry and agricultural commodity exports. In addition, the contribution of crops to real GDP growth during the past decade averaged 0.3 percentage points, indicating persistent sluggish crop value-added growth.

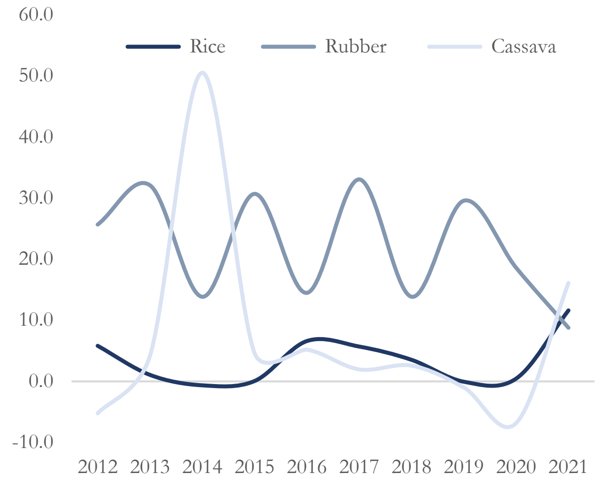
Consumption strengthened, despite the oil and food price shock

Improved confidence supported a recovery of domestic consumption, despite elevated inflation. Consumption, which accounts for about three-quarters of GDP, has been boosted by improved consumer confidence as efforts to contain COVID-19 infections paid off. Imports of consumer and durable goods have recovered since the second quarter of 2022 (figure 12). During the first 8 months of 2022, quantity imports of consumer goods such as beer, garment, and gasoline accelerated, growing at 39.6 percent, 8.8 percent, and 21.4 percent, respectively, y/y. Similarly, quantity imports of durable goods such as passenger cars and motorcycles rose to 53.9 percent and 32.3 percent y/y during the same period. Other imported goods such as foodstuff and electronics, which sharply contracted before the reopening up of the economy and the lifting of travel restrictions, have stabilized. The revival of domestic consumption has also helped underpin a gradual recovery of the services sector, especially the wholesale, retail, travel, and tourism industries.

The food and oil price shock caused inflation to surge

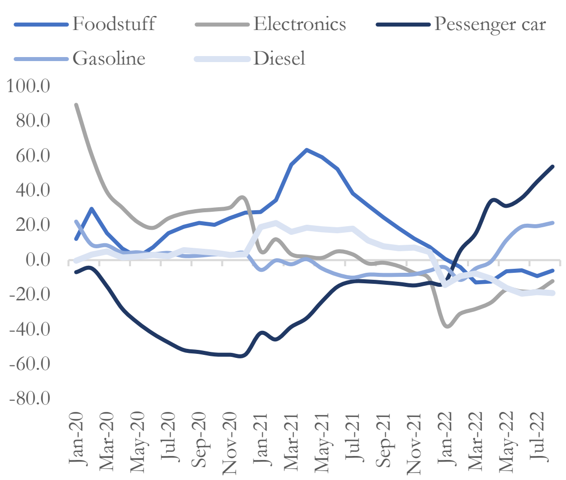
Cambodia's Consumer Price Index (CPI) surged, led by rising food and oil prices triggered by the Russia-Ukraine war. Headline inflation, however, marginally eased to 4.9 percent y/y in August 2022, after surging to 7.8 percent, a 13-year high in June 2022, caused largely by rapidly rising prices of food and petroleum products (figure 13). Given the fact that the food component

Figure 11. Unlike rice, rubber and cassava production remained highly volatile
(y/y percent change)



Source: Cambodian authorities.

Figure 12. Despite rising inflation, consumption improved
Quantity of key imported products
(YTD, y/y percent change)



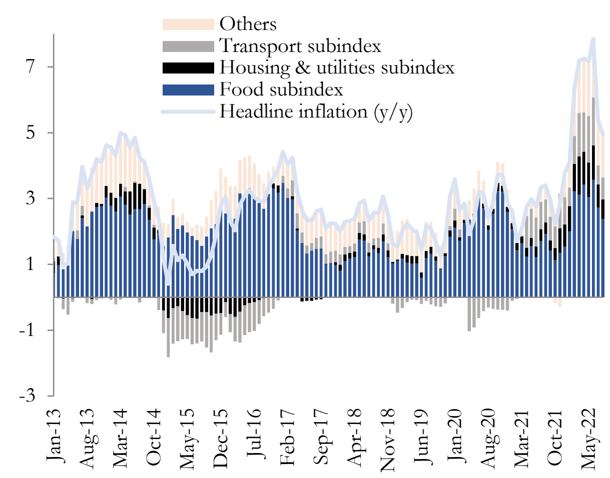
Source: Cambodian authorities.
Note: YTD = year to date; y/y = year on year.

(subindex) captures a 43 percent weight of the inflation basket, excluding food, inflation reached only 2.6 percent y/y in August 2022, up from 1.5 percent in August 2021. During the same period, the food subindex rose to 2.4 percentage points, up from 1.9 percentage points, driven largely by rising prices of rice, beef, chicken, fish, and fresh fruits. Similarly, the contribution of the housing (and utilities) subindex increased to 0.6 percentage points, up from 0.3 percentage points, as the cost of housing maintenance and repair materials soared, reflecting spillovers from the oil price shock. Similarly, combined subindexes of communication, recreation, education, restaurant, and others, contributed 1.3 percentage points in August 2022, up from 0.4 percentage points during the same period last year. The contribution of the transport subindex, however, remained at 0.7 percentage points, despite continued elevated oil prices.

The spillover effects of the food and oil price shock caused rising costs of other goods, labor, and fees. The CPI of selected goods that include household furnishing goods, construction materials, and appliances almost doubled, reaching 4.3 percent in August 2022, up from 2.3 percent in August 2021 (figure 14). Similarly, the spillover effects of the shock caused rising labor costs. Inflation of selected types of labor (services), including housing maintenance, cleaning and repair, and medical/personal care, tripled, reaching 3.4 percent, up from 1.2 percent during the same period last year. Inflation of selected fees, which include utilities, transport, education, and recreation, almost doubled, reaching 5.3 percent, up from 2.4 percent during the same period last year. Cambodia imports 100 percent of its petroleum products. The fuel products it imports also account for a relatively large proportion of GDP (6.2 percent), suggesting that price rises may have a comparatively larger impact on economic activity, weighing on household budgets. While the income effects hit consumer demand, higher input costs constrain production. (See also the Special Focus section below, entitled "Poverty and Distributional Impact of Inflation in Cambodia.")

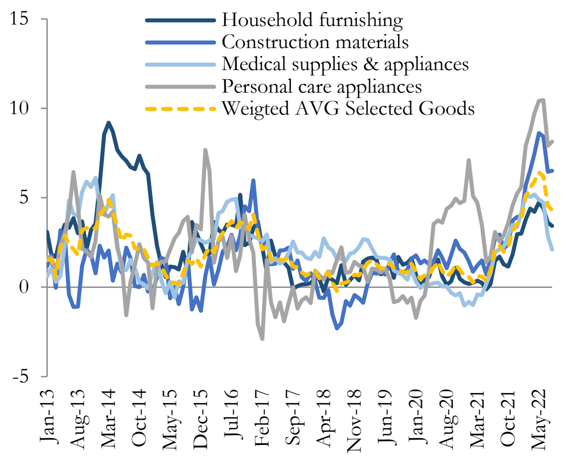
Given that the economy is highly dollarized, it is important to differentiate impacts of the food and oil price shock on purchasing power of those who hold U.S. dollar-denominated assets (that is, those who earn income in U.S. dollars) and those who hold riel-denominated assets (those who earn income in riel). The current inflation rate of 4.9 percent y/y in August 2022 is in local currency terms. With the marginal depreciation of the local currency vis-à-vis the U.S. dollar exchange rate, the computed inflation rate in U.S. dollar terms was 4.2 percent y/y in August 2022,[9] below the inflation rate of 4.9 percent in local currency terms. If a sharp local currency depreciation occurs, the oil

Figure 13. **Inflation eased after surging**
Contribution to 12-m inflation
(percentage points)



Sources: Cambodian authorities.
Note: y/y = year-on-year.

Figure 14. **Selected goods inflation remained elevated**
(y/y percent change)



Sources: Cambodian authorities.
Note: AVG = average.

[9] Inflation in U.S. terms is defined as the ratio of the changes of CPI indexes to the changes of the riel vs. U.S. dollar exchange rate indexes. The riel vis-à-vis U.S. dollar exchange rate is first indexed, using the same base year as that of CPI. If the riel vis-à-vis the U.S. dollar exchange rate indexes are unchanged, the computed inflation in U.S. dollar terms is equal to inflation in local currency terms. As the local currency depreciates against the U.S. dollar, the index of the riel vis-à-vis the U.S. dollar exchange rate increases, and the ratio of the changes of CPI indexes to changes of the exchange rate indexes decrease. Inflation in U.S. dollar terms is, in this case, lower than that in local currency terms.

and food price shock will harm the purchasing power of those who earn income in riel more. Given that Cambodia's economy is highly dollarized, and the riel has been largely pegged to the dollar, rising inflation in the United States has led to rising domestic price pressures, which often results in "imported" inflation.

The current account balance improved, despite deterioration of the terms of trade

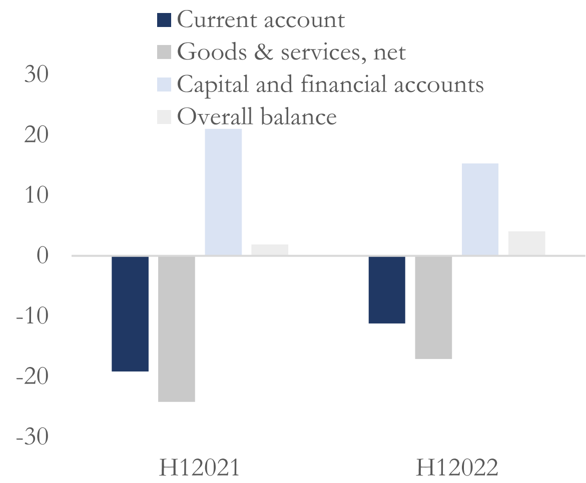
The current account improved in the first half of 2022 as the trade deficit narrowed, according to the central bank's balance of payments data.[10] Cambodia's goods export growth accelerated, surpassing its pre-pandemic growth rate. In the first 8 months of 2022, merchandise exports surged, growing at 28.6 percent y/y, driven largely by exports of main manufacturing products, namely garment, travel goods, and footwear, which grew at 30.3 percent y/y. Merchandise imports growth eased to 18.3 percent y/y. This led to temporary improvements in the trade balance. Gold imports during the first 8 months remained strong, reaching US$4.2 billion, or an 11.2 percent y/y increase. With a broad-based improvement in economic activity including some recovery of the travel and tourism industry, net services also improved. In the first half of 2022, the net exports of services amounted to US$746 million (2.5 percent of GDP), up from US$311 million (1.1 percent of GDP) in 2021. As a result, the current account deficit narrowed to an estimated 11.2 percent of GDP in the first half of 2022 (figure 15) and is projected to reach 25 percent of GDP in 2022.

The exchange rate is also being affected by tightening global financial conditions. Central banks, including the U.S. Federal Reserve, continue to hike interest rates to keep rapid inflation from becoming entrenched (see the monetary section below for more discussion on rising interest rates). Financing the current account deficit is therefore being constrained by slower capital inflows. As a result of interventions to stabilize the currency, Cambodia's gross international reserves declined marginally to US$18.4 billion (about 8 months of imports) in August 2022, down from US$20.2 billion at the end of 2021.

Diesel and fertilizer imports declined as prices increased

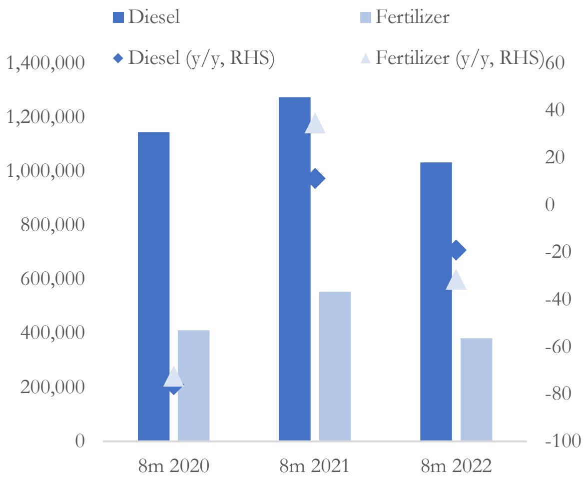
In the East Asia and Pacific (EAP) region, Cambodia is among a few countries that are heavily dependent on fuel imports. The country's refined oil imports amounted to 6.2 percent of 2021 GDP—larger than in most other EAP economies—and around 11 percent of total imports. Caused by the oil price shock, the country's terms of trade have worsened. To cope with the worsening terms of trade, imports of diesel and fertilizer shrank. During the first 8 months of 2022, the quantity of diesel and fertilizer imports declined by 19 percent and 31.3 percent y/y, respectively (figure 16). As agricultural machinery is

Figure 15. The current account improved
(percent of GDP)



Source: Cambodian authorities and World Bank staff estimates.
Note: H1= first half.

Figure 16. Declining diesel and fertilizer imports likely caused by the oil price shock
(metric tons)



Source: Cambodian authorities.
Note: RHS= right-hand scale; y/y = year-on-year.

[10] https://www.nbc.org.kh/english/economic_research/balance_of_payment_data.php.

run by diesel, while agricultural cultivation needs fertilizer and pesticides, the decline of diesel and fertilizer imports does not bode well for this year's agricultural production. As discussed in the agriculture section above, this year's rice cultivation is already slower than last year's.

While remaining stable, the exchange rate continued to be under pressure

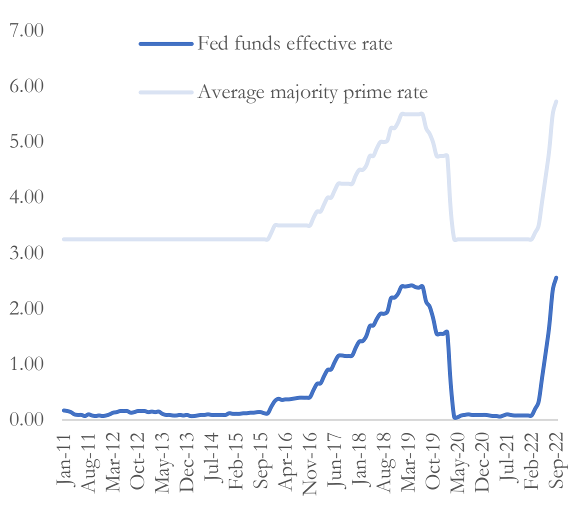
To curb rising domestic inflation in the U.S., the U.S. Federal Reserve (the Fed) raised interest rates (figure 17). The Fed introduced a federal funds rate hike of 0.75 percentage points to a range of 3 percent to 3.25 percent in September 2022.[11] Tightening global financial conditions and deterioration of Cambodia's terms of trade put increased pressure on the exchange rate. While pegged within the targeted ±2 percent range, the nominal exchange rate depreciated, reaching 4,150 riels per U.S. dollar in October 2022, down from 4,074 riels per U.S. dollar during the same period last year. As the riel is pegged to the U.S. dollar, which is appreciating, the local currency appreciated against the currencies of several of Cambodia's main trading partners. The riel/Thai baht exchange rate appreciated, reaching 113 riel per baht, down from 126 riel per baht. The riel/Chinese yuan exchange rate appreciated to 595 riel per yuan, down from 631 riel per yuan. The riel/Vietnamese dong exchange rate appreciated to 0.175 riel per dong, down from 0.179 riel per dong. The riel also appreciated against the euro and the British pound. The appreciation of the riel against currencies of its trading partners such as Vietnam and Thailand erodes Cambodia's external competitiveness.

Broad money growth decelerated despite accommodative monetary policy

Cambodia's central bank, the National Bank of Cambodia (NBC), continued to maintain a reserve requirement ratio of 7 percent for both riel and U.S. dollar deposits and borrowing. The NBC, however, ended forbearance on restructurings from July this year. Driven by the easing of foreign currency deposits (FCDs), broad money (M2) growth decelerated to 12.0 percent y/y in August 2022, down from 16.1 percent during the same period last year (figure 18). Of the 12.0 percent broad money growth, the contributions of foreign currency deposits (and other deposits), transferrable deposits, and currency in circulation accounted for 11.6 percentage points, 1.1 percentage points, and -0.8 percentage points, respectively, down from 12.2 percentage points, 2.4 percentage points, and 1.5 percentage points, respectively, during the same period last year.

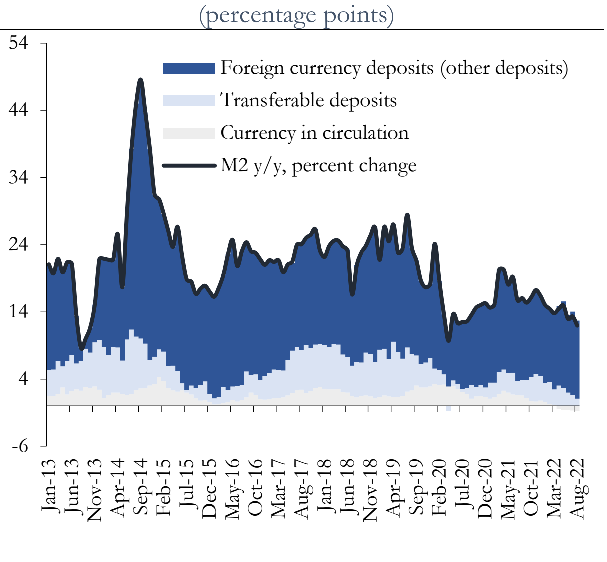
The easing of FCD growth likely reflects decelerated capital inflows. For many years, FCDs have been considered a proxy for capital inflows. Tightening global financial conditions and China's zero-COVID policy may have been curtailing capital inflows to Cambodia. As capital

Figure 17. The Fed kept raising interest rates
(percent per year)



Source: U.S. Federal Reserve.

Figure 18. Broad money growth decelerated
Contribution to broad money growth
(percentage points)



Source: Cambodian authorities.

[11] Minutes of the Meeting of September 20–21, 2022, U.S. Federal Reserve, Washington, DC; https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20220921.pdf.

inflows decelerate, injection of local currency into circulation is increasingly constrained, given that the economy remains highly dollarized. The contribution of (local) currency in circulation to broad money growth, therefore, declined to negative 0.8 percentage points in August 2022, down from 1.5 percentage points during the same period last year. The negative contribution of local currency in circulation to broad money growth may also reflect interventions by the central bank in the foreign exchange market by injecting U.S. dollars.

To mitigate the impact of the pandemic on borrowers, the central bank allowed banks and microfinance institutions (MFIs) to restructure loans. By mid-2022, 268,042 borrower accounts (8.1 percent of total borrower accounts) amounting to US$4.5 billion (8.6 percent of total outstanding credit) provided by the banking sector to the private sector had been restructured.[12] Of the total US$4.5 billion in restructured loans, the construction, tourism, transport and logistics, and garment sectors accounted for US$0.82 billion (18.6 percent), US$0.71 billion (16.0 percent), US$0.21 billion (4.9 percent), and US$0.13 billion (3.1 percent), respectively. The other sectors accounted for the remaining US$2.5 billion (57.5 percent).

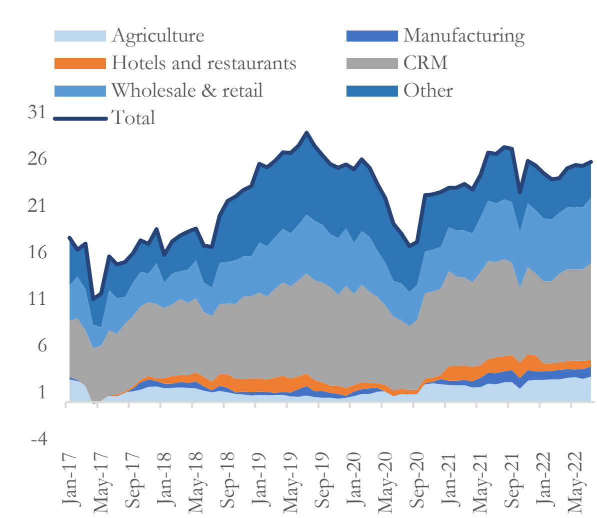
Some easing of credit growth, but concentration of credit in real estate continued

While remaining strong, domestic credit growth decelerated to 22.7 percent y/y in August 2022, down from 26.2 percent during the same period last year (figure 19). Concentration of domestic credit in the construction and real estate sector continued despite the easing of construction activity after the construction boom stalled. As of August 2022, of total bank credit growth, the contribution of construction, real estate, and mortgages combined rose to 40 percent, up from 36 percent during the same period last year. While all major (real) indicators (approved construction permits and imports of construction materials) point to the easing of construction and real estate activity, domestic credit financing the construction, real estate, and mortgage sectors expanded. This may indicate increased property speculation activity. Reflecting a recovery of domestic economic activity, the contribution of lending to wholesale/retail and agriculture to credit growth rose to 27 percent and 11 percent, respectively, in August 2022, up from 24 percent and 8 percent, respectively, during the same period last year. The credit-to-GDP ratio increased further, to 171 percent in August 2022, up from 158 percent during the same period last year.

Pressures on domestic interest rates emerged

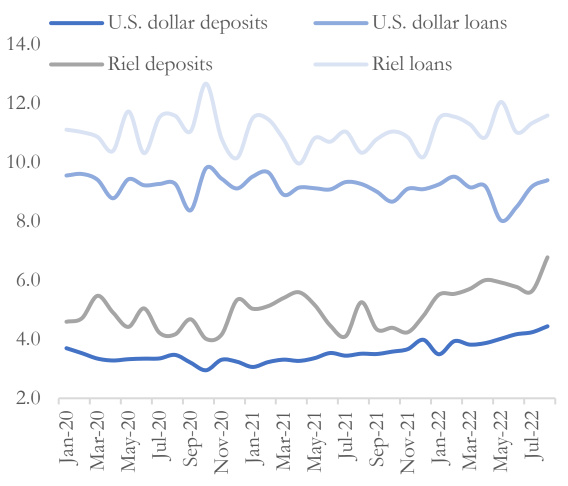
Significant tightening of financial conditions, as central banks such as the U.S. Federal

Figure 19. Concentration of credit in real estate
Contribution to domestic credit growth
(percentage points)



Source: Cambodian authorities.
Note: CRM = construction, real estate, and mortgage.

Figure 20. Domestic interest rates started to increase
(percent per year)



Source: Cambodian authorities.

[12] National Bank of Cambodia 2022.

Box 2. Are risks from rising private debt a concern?

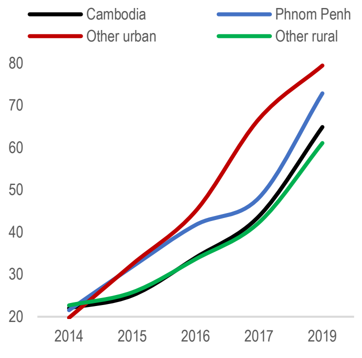
Cambodia experienced a rapid financial deepening during the past 10 years. Credit provided by the banking and microfinancing system reached 159.8 trillion riels (US$38.9 billion) or 145 percent of GDP in 2021,[a] up from 14.7 billion riels or 13.5 percent of GDP in 2012. This is a formal credit amount, which excludes non-bank financial intermediary credit such as mortgages provided by housing and real estate developers and informal loans provided by pawnshops, traders, family, and friends. Modernization of the banking system and proliferation of microfinance institutions have improved access to formal loans. As a result, the ratio of household indebtedness to GDP exploded from 2.5 percent to 34.4 percent during 2010–21.[b] Formal credit from banks rapidly expanded, growing at an annual rate of 24.3 percent during 2017–21.[c]

Similarly, evidence from Cambodia Socio-Economic Surveys (CSES)[d] also shows Cambodia's household indebtedness-to-consumption ratio soared from 20 percent in 2014 to 65 percent in 2019 (figure B.2.1). Compared to other countries of similar development stage, Cambodia's ratio of household debt to GDP is exceptionally high (figure B.2.2). In addition, household loans are found not to be productively used, raising concern that excessive borrowing can force households to fall into a vicious debt trap. Productive loans, which consist of loans used for agriculture and nonagricultural activities, accounted for only 28 percent of the total (figure B.2.3).

An analysis of secondary data from CSES and the National Bank of Cambodia indicates that almost one-fifth of household loans were used to purchase or improve dwellings, while the contribution of credit to the real estate and construction sector was almost one-third of the total growth of bank loans in 2021. As of July 2022, bank loans provided to nonfinancial institutions and for personal essentials accounted for 105.2 percent of GDP and 32.6 percent of GDP, respectively (figure B.2.3). In addition, there is an unknown outstanding amount of mortgage loans provided by housing and real estate developers that compete with one another by providing attractive financing options and easy lending standards to their customers with loan-to-value ratios ranging from 40 percent to 100 percent. There is a need to rein in the high credit growth and the concentration of credit in the real estate sector.

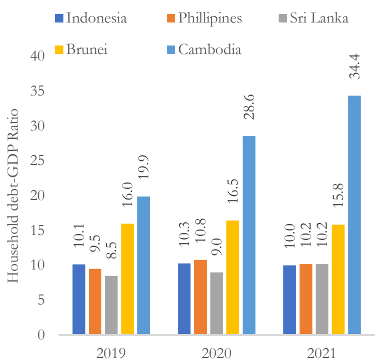
A large literature in economics, dating back at least to the work of Minsky (1977, 1986) and Kindleberger (1978), views rapid credit expansion as a prelude to financial crises.[e] Empirical studies have also found that lending to households is more likely to be associated with financial stress and economic downturns than lending to the nonfinancial corporation sector. A large and growing body of empirical work has found that high levels of and/or rapid increases in aggregate private nonfinancial sector debt are key predictors of the likelihood, severity, and duration of future financial crises and subsequent economic downturns.[f]

Figure B.2.1. Household debt-to-consumption ratio
(percent)



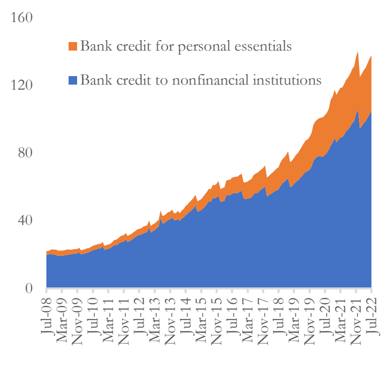
Source: Cambodia Socio-Economic Surveys for 2014–16 and 2019.

Figure B.2.2. Household debt-to-GDP ratio
(percent)



Source: https://www.ceicdata.com/en.

Figure B.2.3. Cambodia's Private debt
(percent of GDP)



Source: Haver Analytics.

a. National Bank of Cambodia, Mid-2022 Report, June 2022. b. https://www.ceicdata.com/en/indicator/cambodia/household-debt--of-nominal-gdp. c. National Bank of Cambodia 2021. d. National Bank of Cambodia 2021. e. Bank for International Settlements 2022. f. Claessens et al. 2012; Drehmann et al. 2012; Schularick and Taylor 2012. g. Borio et al. 2018.

Reserve and the European Central Bank[13] raised interest rates, put upward pressure on domestic interest rates in Cambodia. Rising funding costs for banks and financial institutions in Cambodia pushed up operating costs of banks and MFIs, requiring them to increase interest rates on loans. Weighted average interest rates of U.S. dollar-denominated term deposits and loans rose to 4.4 percent and 9.39 percent per year, respectively, up from 3.51 percent and 9.0 percent, respectively, during the same period last year (figure 20). Similarly, weighted average interest rates of local currency-denominated term deposits and loans rose to 6.78 percent and 11.59 percent per year, respectively, up from 5.26 percent and 10.33 percent, respectively, during the same period last year. The prospect of a protracted period of high inflation and a sharp increase in global interest rates has significant implications for Cambodia.

Deposit growth eased, expanding at 14.2 percent y/y in August 2022, compared to 16.1 percent during the same period last year. The easing of domestic deposits may have compelled banks and MFIs to raise interest rates on deposits to attract depositors. The loan-to-deposit ratio continued to increase, reaching 134.7 percent in August 2022, up from 125.3 percent during the same period last year. As the demand for credit increased, some banks continued to lend, regardless of the domestic deposits they received, because they obtained funding abroad. However, with the tightening global financial conditions, borrowing costs from abroad increase, pushing up domestic borrowing costs. By mid-2022, the reported overall nonperforming loan ratios remained low at 2.6 percent and 2.3 percent for the banking and microfinance sectors, respectively.[14] However, this may not fully reflect declining asset quality, due to extensive loan restructuring allowed during the height of the COVID-19 pandemic. Cambodia's high private debt raises concerns about the drag on the economy if borrowers struggle to meet repayments.

The economy remains highly leveraged

A rising credit-to-GDP ratio, which reached 171 percent in August 2022, reflects a rapid buildup of private debt (see box 2 for a discussion on private debt). Credit growth has far exceeded growth in nominal GDP for more than a decade. Cambodia's bank credit as a percentage of GDP overtook that of Indonesia and the Philippines in 2017, despite Cambodia's nascent banking sector. Domestic credit growth averaged 26.02 percent during 2011–21. Total outstanding loans financed by the banking and microfinance sectors surged and are projected to reach 180 percent of GDP by end-2022, up from 9.6 percent of GDP in 2009. Banks accounted for 80 percent of the loans, while the microfinance sector accounted for the remaining 20 percent. This excludes credit provided by the "shadow banking" system. According to the National Bank of Cambodia, the banking sector's assets grew by 17.2 percent to US$69.5 billion as of December 2021, despite the negative effects of the COVID-19 pandemic. Loans to consumers increased by 22.7 percent to US$46.7 billion, while consumer deposits rose by 16.5 percent to US$39.2 billion.

While the spillover effects from a slowdown in the real sector to the financial sector have not yet been sizable, the tapering of capital inflows triggered by tightening global financial conditions, and China's zero-COVID policy is affecting property prices. Outstanding bank credit provided to combined construction, real estate, and mortgage activities rose to US$14.5 billion (48 percent of GDP) by July 2022, up from US$7.9 billion (28.6 percent of GDP) by end-2019. A real estate market correction may have started, which is likely to increase NPLs in this segment. High credit growth and concentration of domestic credit in the construction and real estate sector remain a key risk to Cambodia's macrofinancial stability.

Domestic revenue collection quickly recovered

A broad-based economic recovery and revenue administration improvements underpinned an across-the-board improvement in domestic revenue collection. Domestic revenue growth fully recovered to pre-COVID-19 levels. During the first 8 months of 2022, central government revenue, which accounts for 92.1 percent of total domestic revenue, surged, reaching 16,712 billion riels (US$4.08 billion) or 23.8 percent y/y, driven

[13] "The Governing Council today decided to raise the three key ECB interest rates by 75 basis points in September 2022" (European Central Bank 2022).

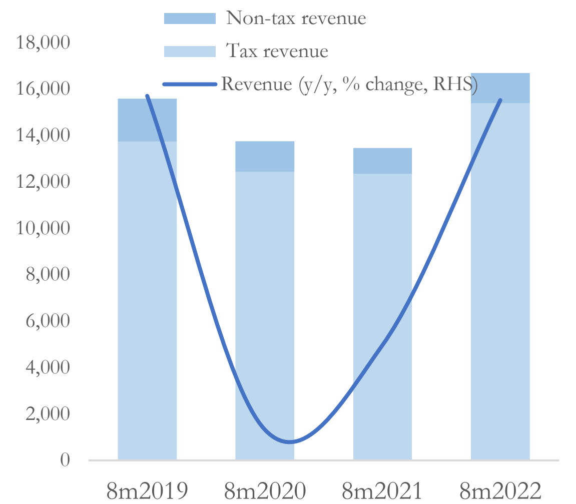
[14] National Bank of Cambodia 2022.

largely by buoyant tax revenue (figure 21). Tax revenue grew at 24.6 percent y/y, amounting to 15,392 billion riels (US$3.75 billion), thanks mainly to better collection of both taxes on goods and services (indirect taxes) and direct revenue (direct taxes). Although Cambodia's domestic revenue continued to depend on taxes on goods and services, comprising mainly the value-added tax (VAT) and excises, direct revenue improved steadily in recent years. The share of direct revenue to total tax revenue rose to 40.4 percent during the first 8 months of 2022, up from 27.1 percent during the same period in 2019, propelled by a rapid expansion of profit taxes, which grew by 25.9 percent. Improvements in tax collection continued, thanks to better tax administration and modernization, with the introduction of e-filing, e-payment, and better taxpayer services. Efforts have been made to eliminate loopholes in the Law on Taxation and to harmonize the legal framework to prevent fiscal evasion, transfer pricing abuses, and double taxation.[15]

Profit tax is now the largest component of domestic revenue

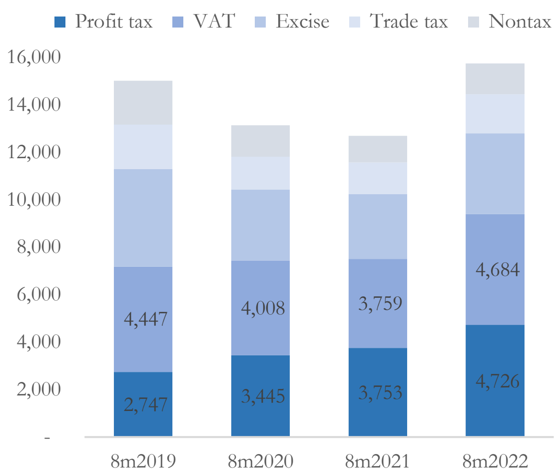
In 2022, profit tax collection rose quickly, exceeding VAT collection for the first time. During the first 8 months of 2022, profit tax collection grew by 25.9 percent, reaching 4,725.5 billion riels (US$1.15 billion) (figure 22). Boosted by profit tax collection, the share of direct revenue in domestic revenue rose to 28.3 percent during the first 8 months of 2022, up from 17.5 percent during the same period in 2019. However, implementation of the newly introduced Law on Investment, which is more generous than the old law, will likely have a negative impact on profit tax collection. Direct revenue is expected to be further boosted if a personal income tax is finally introduced. There is no personal income tax, per se, in Cambodia. Instead, a monthly salary tax is imposed on individuals who derive income from employment.[16] The monthly salary tax, which has been implemented for decades, remains relatively small. Due to the absence of personal income tax, Cambodia's direct revenue as a share of total revenue remained relatively low, reaching only 25.0 percent in 2020, compared to 30.1 percent in Thailand, 36.6 percent in the Philippines, and 45.2 percent in Malaysia. The second largest revenue component is the VAT. During the first 8 months of 2022, VAT revenue grew by 24.6 percent, amounting 4,684 billion riels (US$1.14 billion). However, the share of VAT remains stable at 28 percent of total domestic revenue. Large taxpayers contributed about 80 percent of total tax revenue.[17] Despite increased commitments under bilateral and regional free trade agreements, taxes on international trade also grew, expanding at 22.4 percent y/y. Nontax revenue, driven largely by travel and tourism activity and hit hard during the pandemic, also improved, rising 16.1 percent y/y. During the first 8 months of 2022, domestic revenue collected by the two main revenue agencies—the General Department of Taxation,

Figure 21. **Central government revenue growth recovered**
(billion riels)



Source: Cambodian authorities.
Note: RHS = right-hand scale.

Figure 22. **Profit tax collection rapidly expanded**
Main components of domestic revenue
(billion riels)



Source: Cambodian authorities.

[15] Royal Government of Cambodia 2021a.
[16] See https://taxsummaries.pwc.com/cambodia/individual/taxes-on-personal-income.
[17] Royal Government of Cambodia 2022b.

which is responsible mainly for collecting domestic taxes, and the General Department of Customs and Excise, which is in charge of collecting largely trade-related taxes—accounted for 50.1 percent and 41.9 percent of domestic revenue, respectively. Strong performance of domestic tax collection is attributed to good tax administration, tax system modernization, and good corporate governance.[18]

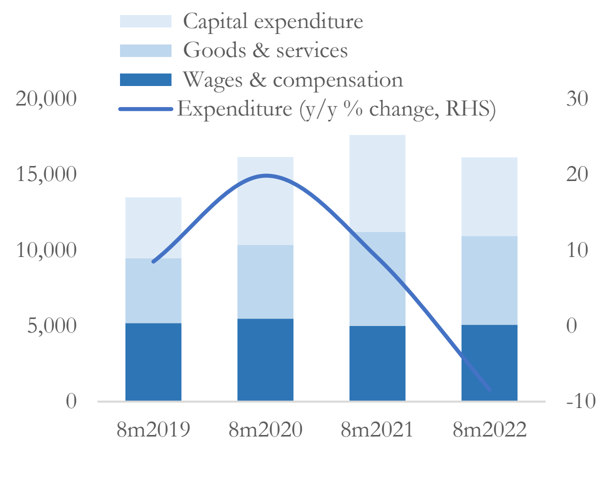
Budget expenditure gradually decelerated amid fiscal consolidation efforts

After accelerating during the past two years to meet rising pandemic-related spending demand, spending decelerated this year. During the first 8 months of 2022, central government expenditure contracted by 8.4 percent y/y, amounting to 16,138.9 billion riels (US$3.94 billion) (figure 23). The decline was caused mainly by slow capital expenditure. Capital expenditure slowed, declining by 18.9 percent y/y, reaching 5,200 billion riels (US$1.27 billion), of which half was externally financed. Current expenditure also moderated, marginally declining by 2.4 percent, reaching 10,938 billion riels (US$2.67 billion), of which 53.5 percent was goods and services (nonwage) spending. Expenditures on goods and services declined by 6.0 percent as some COVID-19 support measures, especially COVID-19-related health expenditures, have been phased out. Similarly, social benefit spending slowed, reaching only 1,531 billion riels (US$0.37 billion) during the first 8 months of 2022, down from 2,163.4 billion riels (US$0.53 billion) during the same period last year. Wages and compensation grew marginally, increasing by 2.0 percent, reaching 5,088 billion riels (US$1.24 billion). Wages and compensation remained contained as public sector salaries have been frozen since 2021 to save budgetary funds to meet rising pandemic-related spending demand. In July 2022, while planning to introduce additional assistance programs, the authorities extended the cash transfer programs to the end of 2022 to address the negative impacts of the food and oil price shock, as well as the ongoing effects of the pandemic. The program benefits approximately 706,060 households (2.8 million individuals) or 17 percent of the population. Launched in June 2020, as of October 2022, the program had disbursed US$837.05 million (about 2.7 percent of GDP).

The fiscal deficit is expected to narrow, but remains relatively large at 4.6 percent of GDP

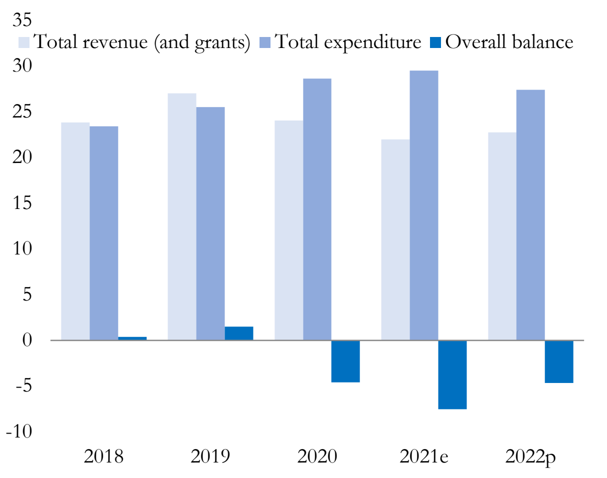
Thanks to improved collection and consolidated expenditure, the fiscal deficit is expected to narrow, reaching 4.6 percent of GDP in 2022 (figure 24). Revenue, including grants, is rapidly improving and is projected to reach 22.8 percent of GDP in 2022, boosted largely by buoyant tax revenue, thanks to economic recovery and continued revenue administration

Figure 23. **Central government expenditure consolidated**
(billion riels)



Source: Cambodian authorities.
Note: RHS= right-hand scale.

Figure 24. **The general government deficit narrowed**
(percent of GDP)



Source: Budget Settlement Laws; and World Bank staff estimates and projections.
Note: e = estimates; p = projections.

[18] General Department of Taxation, press release, 2022 Eurocham Cambodia Tax Forum, October 26, 2022.

improvements. Expenditure is expected to decline to 27.4 percent of GDP as expenditure on goods and services and capital expenditure are moderating as some pandemic-induced spending such as COVID-19-related health expenditures have been phased out.

The fiscal deficit is projected to be largely financed by external funds. External financing is expected to account for about 90 percent of the financing gap (see more discussion on loan disbursements in the public debt section below). The remaining 10 percent is expected to be financed by a drawdown of government deposits (fiscal reserves), which stood at 17.1 percent of GDP by August 2022, down from 23.7 percent at the end of 2020.

Public debt stock reached 32.3 percent of GDP and China remained Cambodia's largest creditor

By mid-2022, Cambodia's public debt-to-GDP ratio reached 32.3 percent or US$9.7 billion in outstanding debt (table 1),[19] of which 68 percent is owed to bilateral creditors and 32 percent to multilateral creditors. Triggered by the pandemic, Cambodia's debt accumulation picked up amid slow revenue collection and rising demand for health and social assistance spending, resulting in a widening financing gap. To finance the gap, the country's public debt, which consists almost solely of external debt, rose quickly to 32.5 percent of GDP in mid-2022, up from 28.2 percent in 2019. Cambodia's largest official creditor is China. Total debt owed to China reached US$4.04 billion, or 41.5 percent of total debt stock by mid-2022. Cambodia's second largest creditor is the Asian Development Bank, to which it owed US$1.97 billion, or 20.2 percent of the total. Cambodia's third, fourth, and fifth largest creditors are Japan, the World Bank, and the Republic of Korea, accounting for 10.0 percent, 9.2 percent, and 7.7 percent of total outstanding debt, respectively. Old debt accounted for 6.89 percent of the total.

U.S. dollar-denominated debt remained the largest, accounting for 42.5 percent of total debt stock, followed by Special Drawing Rights (SDR)-denominated debt, at 23.7 percent. Although China is Cambodia's top creditor, the country's public external debt denominated in Chinese yuan accounted for only 15.0 percent of total debt stock. Of total debt stock, 52 percent financed the country's public infrastructure sector such as transport, irrigation, energy, and water supply, while 48 percent funded other prioritized (non-infrastructure) sectors such as health, education, and agriculture.

Disbursements of loan proceeds continued to increase

Total loan disbursements rose to US$848.7 million during the first half of 2022, up from US$578.71 million during the same period last year. The amount of disbursement (US$848.7 million) made during the first half of 2022 already exceeded the total disbursement (US$829.7 million) for all of 2019. The authorities have been filling the pandemic-induced widening financing gap primarily with rising proceeds from loan disbursements, supplemented by drawdowns of government deposits (fiscal reserves). More importantly, the authorities continue to follow the

Table 1. Public debt stock, newly signed loans, and loan disbursements

	Debt stock as of mid-2022		H1 2022 loans		H1 2022 disbursement	
Top 3 bilateral creditors	Amount (US$ million)	Share (%)	Amount (US$ million)	Share (%)	Amount (US$ million)	Share (%)
China	4,043.6	41.5	179.6	28.3	155.2	18.8
Japan	971.6	10.0	147.0	23.1	271.6	32.9
France	472.0	4.8	n.a.	n.a.	31.3	3.8
Top 3 multilateral creditors						
ADB	1,972.0	20.2	95.0	14.9	125.9	15.3
World Bank	891.3	9.2	105.1	16.5	213.7	25.9
IFAD	108.0	1.1	n.a.	n.a.	8.9	1.1
Other bilateral/multilateral creditors	1,282.1	13.2	n.a.	n.a.	n.a.	n.a.
Total	9,740.6	100.0	635.6	100.0	824.7	100.0

Source: Ministry of Economy and Finance 2022.
Note: H1 = first half; n.a. = not applicable.

[19] Cambodia *Public Debt Statistical Bulletin*, Volume 15, August 2022, Ministry of Economy and Finance 2022.

borrowing principle of only contracting external debt on concessional terms to help maintain a low risk of a debt distress rating. In the first half of 2022, loan disbursement from four main creditors—Japan, the World Bank, China, and the Asian Development Bank—accounted for a total of US$766.4 million or 92.9 percent of total disbursement. Japan, the World Bank, China, and the Asian Development Bank disbursed US$271.6 million, US$213.7 million, US$155.2 million, and US$125.9 million, respectively.

Although the country's public debt currently consists mostly of external debt, the government has issued some domestic debt. On September 7, 2022, the first tranche of its Government Bond was launched for 100 billion riels (equivalent to US$25 million) at a 2 percent coupon on one-year maturity. Over the medium term, the introduction of government securities will help gradually diversify financing sources, with a shift toward public domestic debt, while promoting domestic savings. The Joint World Bank/International Monetary Fund Debt Sustainability Analysis (DSA) conducted in 2022 has not been published yet. The DSA conducted in 2021 indicated that Cambodia remained at low risk of external and overall debt distress.[20]

Outlook

Cambodia's real GDP growth projection has been revised up to 4.8 percent in 2022 on the back of a more broad-based economic recovery (table 2). The surge in manufacturing exports—especially garment, footwear, travel goods, and bicycle manufacturing; the revival of the travel and tourism industries; and the return of FDI inflows have helped sustain this year's economic recovery. Even though the economy is expected to further expand next year, supported by a recovery of domestic consumption as employment rates improve and inflation recedes, along with strong government consumption during an election year, real growth projection for 2023 has been downgraded to 5.2 percent due to the less favorable global outlook.

In the short term, the fiscal balance is projected to continue to normalize on the back of stronger growth and better revenue administration. This is expected to result in buoyant revenue performance, while expenditure is expected to ease with the decline in demand for COVID-19 related spending. Inflation is expected to decelerate to 4.2 percent and 3.8 percent in 2023 and 2024, respectively. The external account sees further improvement through relatively resilient exports. Poverty is expected to decline due to the projected economic recovery and moderate inflation.

Over the medium term, the economy is expected to trend back to potential, growing at around 6 percent. The tourism and hospitality industries are likely to accelerate further, with projected increases in international arrivals and domestic tourists once the pandemic is behind us. Agricultural production and agroprocessing industries continue to be boosted by newly ratified free trade agreements. In addition to the Cambodia-China Free Trade Agreement (CCFTA) and the Regional Comprehensive Economic Partnership (RCEP), which have been effective since January 2022, the Cambodia-Republic of Korea Free Trade Agreement (CKFTA) will be effective from December 2022. The travel, transport, and logistics industry should be boosted by strong investment in several key infrastructure projects such as a newly built expressway linking Phnom Penh to Sihanoukville, where a deep-sea port is located; a new logistics complex and multimodal port development project in Kampot; and a new expressway project linking Phnom Penh to Bavet on the Cambodia-Vietnam border.

Challenges and risks

Although the near-term growth outlook has improved marginally since April, risks are tilted to the downside. Global trade growth is projected to slow sharply in 2023 as the global economy faces strong headwinds. According to the World Trade Organization, world merchandise trade volume is expected to slow sharply to 1.0 percent in 2023, down from 3.5 percent in 2022. The dangers of inflation, slow growth, lower productivity, the drain on global energy supplies, and higher interest rates are impacting developing countries. Cambodia's export-oriented manufacturing is vulnerable to an extended slowdown in the United States, Cambodia's largest export market. Similarly, the slowdown in China, Cambodia's largest source of foreign direct investment, if sustained, will negatively impact investment and capital inflows into the country. The European Union, Cambodia's second largest export market, is facing significant downward risks amid high energy prices and inflation.

[20] International Monetary Fund 2021.

Global financial tightening has started to negatively impact the economy. Cambodia has been experiencing a deceleration of foreign currency deposit growth, reflecting the easing of capital inflows. There have been depreciation pressures on the riel/U.S. dollar exchange rate, which required interventions in the foreign exchange market and led to the decline in Cambodia's gross international reserves. As pressures on domestic interest rates emerged, the country's commercial real estate sector faced increased risks.

If elevated energy prices linger, a further deterioration of the terms of trade will undermine consumer confidence and corporate profitability, and potentially prevent the economy from reaching potential growth by 2024. Further, intensifying geopolitical tensions, including a prolonged war in Ukraine, growing stagflationary headwinds, rising financial instability, continuing supply-side constraints, and worsening food insecurity all present serious risks to Cambodia's projected path to economic recovery. Even though Cambodia maintains policy space that it could deploy should these risks materialize, its fiscal buffers have shrunk, after years of government fiscal intervention.

Table 2. The macro outlook indicates continued economic recovery

	2021e	2022p	2023p	2024p
National Accounts and Prices				
GDP at constant market prices (% change)	3.0	4.8	5.2	6.3
Agriculture	1.1	1.3	1.5	1.5
Industry	7.4	8.6	9.1	9.2
Services	-1.0	0.9	2.6	4.9
Consumer Price Index	2.8	6.0	4.2	3.8
General Government (% of GDP)				
Revenue and grants	22.0	22.7	22.6	23.8
Expenditure and net lending	29.6	27.3	27.9	27.2
Overall balance (including grants)	-7.6	-4.7	-5.3	-3.5
Foreign financing	4.2	5.5	4.4	4.1
Net domestic financing (from current savings)	4.4	0.4	2.2	0.7
Amortization	-1.1	-1.2	-1.3	-1.3
Money and Credit				
Broad money (% change)	20.0	15.4	21.0	22.5
Credit to the private sector (% change)	23.2	22.5	28.1	28.5
External Sector (US$ million unless otherwise)				
Exports (goods and services)	18,565.9	23,187.1	28,283.6	34,387.1
Imports (goods and services)	28,120.6	28,492.0	31,117.2	36,405.7
Foreign direct investment, net inflows	3,391.0	3,737.2	4,380.6	5,324.3
Gross official reserves	20,272.3	19,464.8	20,491.8	22,107.7
(months of imports)	9.0	8.1	7.5	7.1
Current account (percent of GDP)	-41.9	-25.0	-15.6	-12.6
Exchange rate (riel per US$ average)	4,100	4,150	4,110	4,100
Debt Stock and Service				
Total public debt (% of GDP)	34.7	36.7	35.6	35.3
Memorandum items:				
Nominal GDP, US$ million	27,400.5	30,171.1	33,579.3	37,319.0

Sources: Cambodian authorities; and World Bank staff estimates and projections.
Note: e = estimates; p = projections.

Policy options

With the recovery from COVID-19 still underway, Cambodia must now navigate through global economic headwinds. While demand for social assistance spending continues, the fiscal space has shrunk. To mitigate impacts of the oil and food price shock, the authorities are planning to introduce additional social assistance measures on top of the existing COVID-19 cash transfer program. Cambodia entered the pandemic with ample fiscal buffers, but the economic contraction in 2020 combined with large (and protracted) spending on health and social assistance led to a substantial increase in the fiscal deficit and the debt level. Once the recovery becomes more entrenched, policies will need to shift towards consolidation to ensure fiscal sustainability and regain fiscal space. In this context, it is important to start broadening the tax base by introducing a personal income tax. Due mainly to the absence of a personal income tax, Cambodia's direct revenue as a share of total domestic revenue remained relatively low at 25 percent in 2020, compared to 30.1 percent in Thailand and 36.6 percent in the Philippines.

Safeguarding financial stability is crucially important. The country's commercial real estate sector faces increased risks as financial conditions tighten. It is crucial to closely monitor the current elevated credit growth, high levels of private debt, rising nonperformance loans, and the concentration of related risks in the construction and real estate sectors to ensure macrofinancial stability. To this end, it is important to safeguard the financial system with bank restructuring, corporate insolvency, deposit insurance, and debt restructuring regulations. There is a need to rein in the high credit growth and the concentration of credit in the real estate sector. Disruptions in the commercial real estate market could in turn potentially threaten financial stability through the connectedness of the sector with the financial system and the broader macroeconomy. Continued vigilance is warranted on the part of financial supervisors to mitigate such risks. In addition, negative impacts of global financial tightening point to the importance of the ongoing efforts of dedollarization.

Promoting the domestic economic sectors, with a focus on the travel, tourism, and hospitality industries, should help partly offset the deterioration of external demand conditions. In this regard, Cambodia must address key issues as indicated in the 2021 World Economic Forum's Tourism and Travel Development Index, in which Cambodia was ranked 79th, compared to 52nd for Vietnam and 36th for Thailand. Those issues include tourism service infrastructure, port infrastructure, environmental sustainability, and business environment. Despite a rapid expansion of the road network during the last several years, the country continues to exhibit insufficient connectivity to secondary destinations and last-mile road networks. There are several issues related to quality of services such as management (and provision) of waste and wastewater, piped clean water supply, and access to reliable electricity that need to be addressed. Those issues can only be resolved with improved destination-level management. In addition, successful facilitation of coherent private sector leadership of the sector should help create a "crowding-in" effect, anchored to comprehensive long-term plans, catalyzed by public seed funding.

It is equally important to address supply chain constraints, which include high logistics and transportation costs to boost exports. The national logistics costs in Cambodia, estimated at 26.4 percent of GDP in 2020, are significantly higher than in comparable Association of Southeast Asian Nation (ASEAN) countries such as Indonesia (22 percent of GDP), Vietnam (20 percent of GDP), and Thailand (14.1 percent of GDP). To this end, it is necessary to address the high inventory cost in Cambodia by promoting access to finance and inventory management capabilities, while reducing transport costs by further facilitating trade. It is also essential to continue addressing supply-side bottlenecks by reducing the cost of energy, doing business, and licensing, especially for the exports sector, to revive external competitiveness.

Part 2: Special Focus

Poverty and Distributional Impact of Inflation in Cambodia

PART 2: SPECIAL FOCUS

POVERTY AND DISTRIBUTIONAL IMPACT OF INFLATION IN CAMBODIA[21]

Introduction

This Special Focus assesses the poverty and distributional impact of inflation in Cambodia, how impacts could be mitigated, and what it would cost to achieve desired distributional and poverty-limiting outcomes. The Special Focus concludes with recommendations to support an inclusive recovery.

High inflation comes at a time when Cambodian households are still recovering from the negative effects of the pandemic. Household finances for many Cambodians were already weakened with the pandemic, with negative effects borne largely by low-wage workers, informal workers, and low-income households. Soaring prices of food and fuel risk exacerbating poverty and vulnerability, especially when coping mechanisms have been eroded. Inflation, which peaked at 7.8 percent year on year (y/y) in June 2022, is starting to weigh on real incomes and the purchasing power of Cambodians.[22] Hence it is crucial to understand the implications of inflation on the most vulnerable segments of the population and the measures that could be taken to alleviate ensuing economic hardships.

Inflation trends and drivers in Cambodia

Cambodia has experienced higher rates of inflation in recent months, hitting a 13-year high in June 2022 and breaking from past trends. At 7.8 percent in June 2022, inflation reached a rate last seen during the 2008 global food crisis (figure S.1). Inflation has since eased, at least temporarily. Going forward, inflationary pressures will likely persist within the context of rising food and energy prices due to the prolonged war in Ukraine and recent oil production cuts by oil-producing nations.

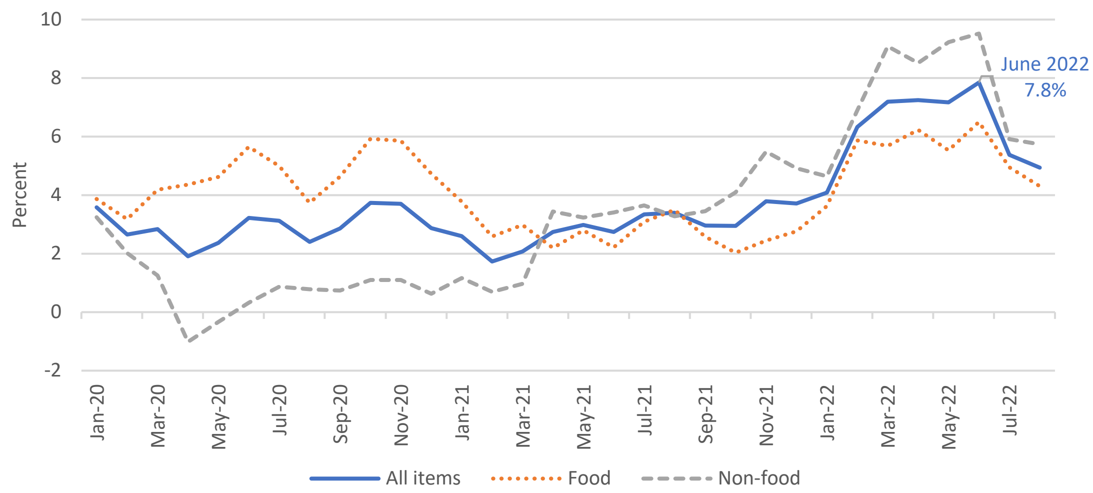
As detailed in the first part of the report, rising global food and energy prices have driven high inflation. While food prices soared in early 2022, non-food inflation has outpaced food inflation, with rising transport costs and housing utilities being important contributors, reflecting higher global energy prices (see figure 13 in part 1).

Prior to 2022, inflation in Cambodia remained low and mostly below 4 percent. In some periods, non-food inflation exceeded national headline inflation while in others food inflation exceeded national headline inflation (figure S.1). In 2020 when the country began grappling with the pandemic, food inflation lingered above national headline inflation. In 2022, in contrast, non-food inflation lingered above national headline inflation. These trends have distributional implications as is discussed later.

[21] This Special Focus was written by Wendy Karamba (Economist, World Bank); Kajetan Trzcinski (Analyst, Centre for Economic Analysis); Kimsun Tong (Economist, World Bank); and Michal Myck (Director of the Centre for Economic Analysis). Communications regarding this section can be sent to wkaramba@worldbank.org.

[22] Purchasing power refers to the amount of goods and services that a unit of currency can purchase. If a household's nominal income does not increase as much as prices, the buying power of that income falls; that is, the households can afford to purchase less.

Figure S.1: Cambodia national headline inflation and food and non-food inflation (percent, y/y)



Source: Cambodian authorities.

Channels of inflation's impact on households

Sharply rising prices erode purchasing power (inflation-adjusted income) and potentially the ability of households to maintain their standard of living. The negative effects of high inflation on household welfare can be transmitted through declining purchasing power. The decline in purchasing power can be most acute when households' nominal income (earnings or transfers) does not increase as much as prices (or do not adjust frequently). The negative impacts of high inflation can also be transmitted through its effects on asset prices, which could lead to a redistribution of wealth between debtors and creditors, depending on initial net asset positions.

While inflation reduces the purchasing power of all households, it can have differential effects across the income distribution. This is because households consume different shares of goods and services, and prices change at different paces for various goods and services. This implies that inflation will differ across households. Inflation will therefore inevitably reduce the purchasing power of some consumers more than others.

The ability of households to cope with high inflation depends on whether their nominal income can keep up or exceed rising household expenses due to inflation, as well as on the amount of savings they have to buffer against income fluctuations.

The welfare implications of rising prices depend crucially on household consumption patterns, employment profile, and asset profile. In this Special Focus, we examine primarily the inflation impacts through consumption.

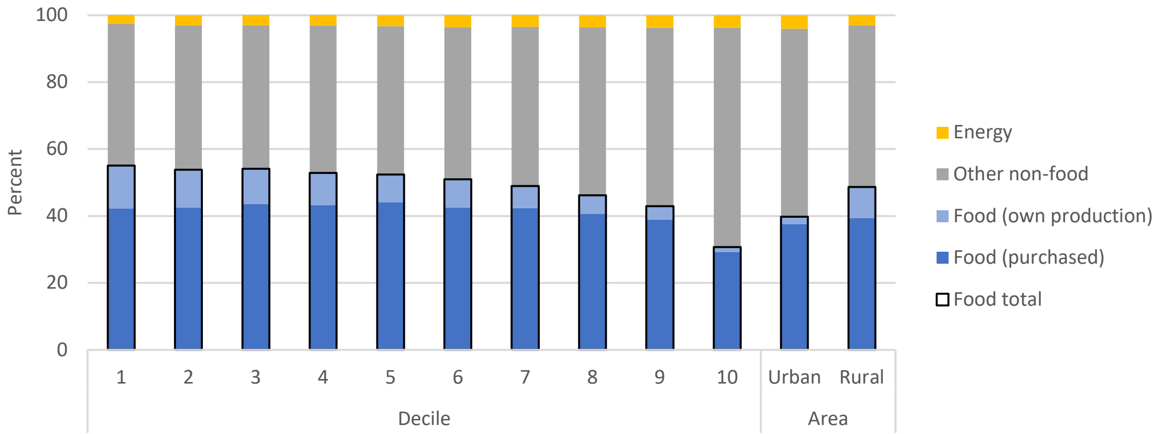
We rely on the latest available national household expenditure data from the Cambodia Socio-Economic Survey (CSES) 2019/20 to examine the consumption patterns across income groups in Cambodia.[23] The 2019/20 data serve as a reasonable baseline for analysis as they are pre-COVID and do not capture the impact of the resulting economic crisis on household incomes and consumption, nor do they account for the large government fiscal response which provided targeted transfers to many households. In 2020, fiscal transfers targeted at poorer households cost around 0.7 percent of GDP and are estimated to have mitigated

[23] The Cambodia Socio-Economic Survey for 2019-2020 was collected from July 2019 to June 2020. The National Institute of Statistics of Cambodia under the Ministry of Planning collects the household survey data.

four-tenths of the poverty impact from the pandemic that year.[24] Spending on household transfers increased in 2021 to 1.4 percent of GDP, and while there are no poverty projections for this period, the poverty-reducing effect of the 2020 transfers combined with a doubling of budget in 2021 suggests that poverty in 2021 may well not be too different than in 2019, the baseline used here for analysis.[25]

Consumption patterns differ across income groups in Cambodia. Poorer households allocate a larger share of their budget to food, and richer households allocate more to non-food items (figure S.2). Accordingly, we would expect increasing food prices to have above-average effects on poor households and increasing non-food prices to have above-average effects on richer households. Since poorer households consume a larger share of food items, they are more likely to be vulnerable to food price increases. Conversely, richer households consume a larger share of non-food items and are more susceptible to non-food price increases.

Figure S.2: Consumption shares across deciles and area



Source: World Bank staff calculations based on the CSES 2019/20.

While spending on energy appears low in comparison to other spending, this spending only reflects direct energy costs incurred by households for transportation, cooking, and other household purposes. However, energy prices are also embedded in food and other non-food expenditures due to transportation and other energy inputs at different stages of the supply chain.

While poor and rural Cambodian households spend about half of their budget on food, a sizeable proportion of food consumption is from own production, partially insulating them from food price increases. Rural farming households may even benefit from higher food prices if they lead to higher agricultural profits. The extent of agricultural profits would depend on whether higher revenues (from increasing output prices) offset higher input costs (from increasing fertilizer and other input costs). However, evidence of the positive relationship between food prices and agricultural income is mixed in the literature as Box S.1 highlights. Still, most of the food consumed by poor and rural Cambodian households is purchased, leaving them open to the effects of increasing food prices.

[24] World Bank (forthcoming).

[25] The poverty rate in 2019/20 with the baseline data was 17.8 percent. Even if the government response did not fully mitigate the impact of the shock by 2021, the slope of the distribution in the range of 20-25 percent would be relatively similar to that of the baseline. Thus, while the poverty *levels* estimated in the current analysis could be biased downwards, the *change* in poverty estimated due to the shock and the mitigation from each policy response scenario should be relatively accurate.

Box S.1: Potential income effects of food prices

Rising food prices can have positive income effects on households, particularly on households that are food producers. For these households, Deaton (1989) proposes that the first-order welfare effect of a price change of a food item is proportional to the difference between the production share of the food item and its consumption share in total household expenditures. This partial equilibrium approach has been widely used to simulate the welfare impact of food price shocks in developing countries (see, for example, World Bank, 2009; Anderson, Ivanic and Martin, 2014; and Ivanic, Martin and Zaman, 2012).

Yet over the medium-term, a general equilibrium framework suggests that the income effect of rising food prices could extend to a broader population. In particular, agricultural laborers are expected to benefit. An increase in food prices raises production incentives, generating a higher demand for factors including labor, which then raises agricultural wages. Several studies find a positive relationship between rice prices and agricultural wages, with econometric estimates that suggest short-run wage elasticities between 0.25 and 0.69 and long-run elasticities between 0.47 and close to unity (Boyce and Ravallion (1991) and Palmer-Jones (1993) for Bangladesh; Lasco, Myers and Bernsten (2008) for the Philippines; and Headey (2016) for several developing countries). Furthermore, Jacoby (2016) considers broader labor market repercussions and finds a positive effect of rising crop prices on wages for manual labor in rural India, both within and outside agriculture.

However, there are also studies that do not find a relationship between food prices and agricultural wages. For instance, even though Rashid (2002) finds a positive relationship between rice prices and agricultural wages for Bangladesh for the period between 1950 and 1989, he finds no relationship for a later period (between 1977 to 1999). Hassan and Kornher (2022) also fail to find a relationship between food prices and agricultural wages for Bangladesh. In both studies the authors argue that urban wages have become a more influential factor in the determination of agricultural wages in the long-run amid increasing urban-rural integration.

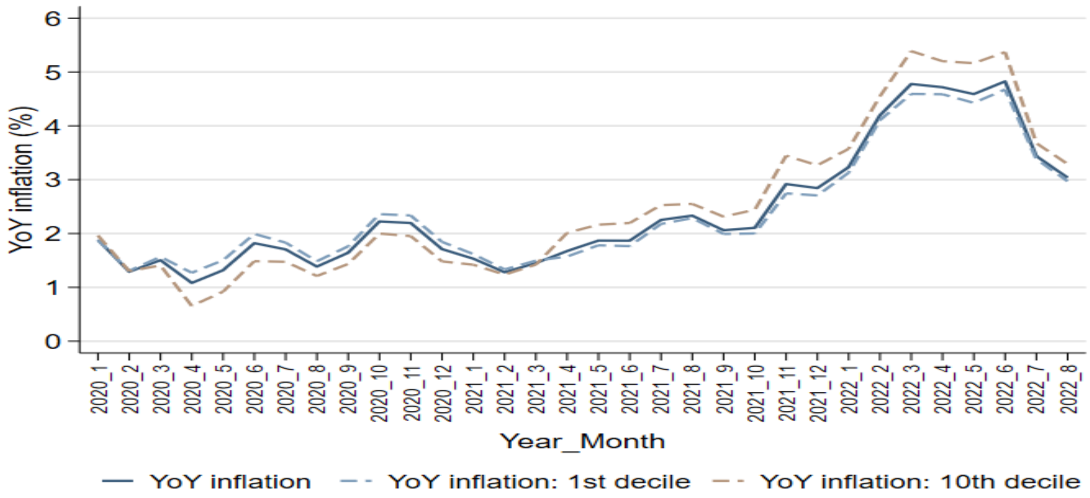
Source: Excerpt from World Bank (2022c).

Inflation inequality

To understand the effect of inflation across household income groups based on their unique consumption patterns, we combine household expenditure data from the Cambodia Socio-Economic Survey (CSES) 2019/20 with the Consumer Price Index. We then trace monthly year-on-year inflation trends adjusting for decile-specific household consumption baskets from the time of survey to August 2022.

As is shown in figure S.3, not all households experience inflation equally at any point in time. Over the past two and a half years, some Cambodian households experienced inflation above the national headline inflation while others experienced inflation below the national headline inflation, reflecting differences in consumption patterns and inflation rates for the items they consume. During the early stages of the pandemic in 2020, food inflation in Cambodia exceeded national headline inflation (figure S.2), causing poorer households to face above-average losses in purchasing power. Since mid-2021, non-food price inflation has exceeded national headline inflation (figure S.2), causing richer households to face above-average losses in purchasing power.

Figure S.3: Cambodia national headline inflation and inflation for top and bottom 10 percent of households adjusted for household consumption baskets (percent, y/y)

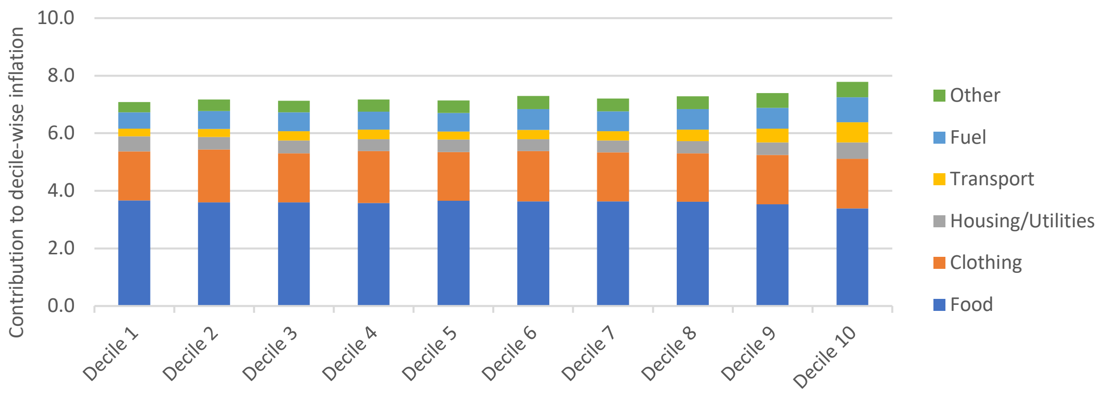


Source: World Bank staff calculations based on the CSES 2019/20 and CPI data.

Distributional impact of inflation

Total inflation faced by households from time of survey to August 2022 does not vary significantly across income groups (figure S.4). This is because higher inflation that was experienced by the poor in 2020 on account of higher food prices is now being offset by higher inflation experienced by the non-poor in 2021 and 2022 (figure S.3). The consumption basket of better-off households is only marginally more expensive, reflecting the effect of higher inflation on non-food items in recent months. As of August 2022, the richest 10 percent experienced inflation that was only 0.7 percentage points higher than that of the poorest 10 percent. Since losses in purchasing power are similar across income groups, we would expect the impact on inequality to be limited (see figure S.13).

Figure S.4: Consumer Price Index adjusted for household consumption and the contribution of different categories to inflation across deciles, August 2022

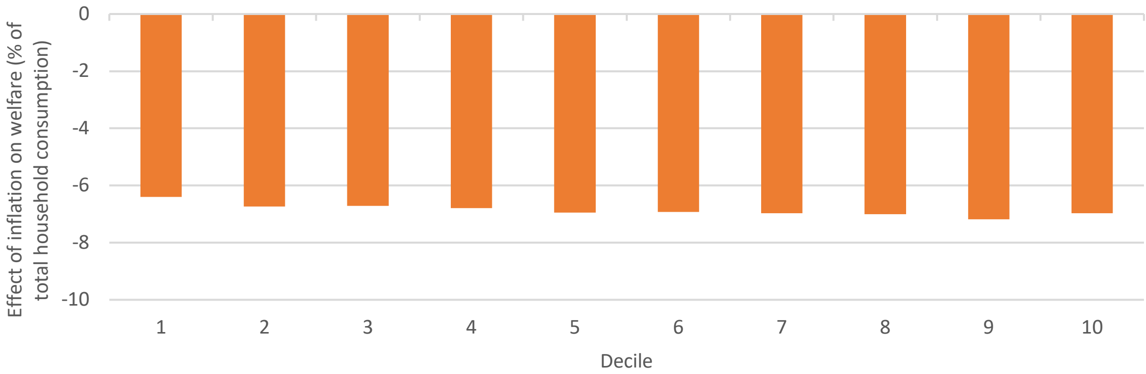


Source: World Bank staff calculations based on the CSES 2019/20 and CPI data.

The urban and rural inflation rates adjusted for household consumption baskets, and the drivers underpinning the changes, are similar. However, it is hard to know exactly the urban-rural differences in inflation rates because a rural consumer price index is not available. In the absence of a rural price index, the Phnom Penh CPI was used to construct decile-specific inflation rates for rural households. This likely overestimates the rural price inflation as rural areas tend to face lower prices than urban areas for some commodities. Hence, any urban and rural differences that we may observe are driven by differences in consumption shares.

Because the magnitude of inflation from 2019/20 to August 2022 is similar across income groups, welfare losses associated with inflation also do not vary substantially across income groups (figure S.5). If the analysis were to focus on the year 2020, the distributional effect would be more pronounced, with the poor experiencing a disproportionate burden. However, since the more recent episode of inflation is higher for non-food items, richer households are experiencing a higher burden.

Figure S.5: Cumulative effect of inflation on welfare by decile, August 2022



Source: World Bank staff calculations based on the CSES 2019/20.

While inflation reduces the real purchasing power of all households, poorer households will have a harder time coping. In general, poorer households have limited savings to draw on to smooth consumption when income or prices fluctuate. When they do have savings, it is crucial they do not draw on these meagre savings as it may further erode their coping mechanisms and have negative consequences on long-term investments in human capital. In contrast, richer households tend to have more liquid assets to buffer against these fluctuations. Further, the poor tend to hold most of their assets in cash rather than interest-bearing assets and are therefore less likely to preserve the real value of their assets. In addition, poorer workers may have jobs where earnings do not grow quickly to outpace inflation, making it more difficult for them to preserve their purchasing power and to build savings.

Faced with a budget constraint, higher prices can lead the poor to reduce consumption and to change their consumption to less expensive and lower-quality goods. Higher prices may also lead the poor to withdraw children from school. As a consequence, inadequate spending on nutritious food, and withdrawal of children from schooling, can have detrimental long-term effects on human capital, causing losses in worker productivity and welfare, and disparities in income in the future.

Evidence from a more recent shock in Cambodia illustrates this point. During the pandemic, the national dropout rate in Cambodia increased in 2019/2020, reversing years of declining trends.[26] More than 60 percent of Cambodian households reduced food consumption to cope with income shocks of the pandemic. Overall, about 90 percent of poor Cambodian households reduced food consumption in response to the initial shock of the pandemic, and about 14 percent poor children ages 6-17 that had previously attended school had dropped out in early 2022.[27]

[26] Ly 2021.
[27] Karamba, Tong, and Salcher 2020. See results of Round 4 and Round 7 of the Cambodia High-Frequency Phone Survey.

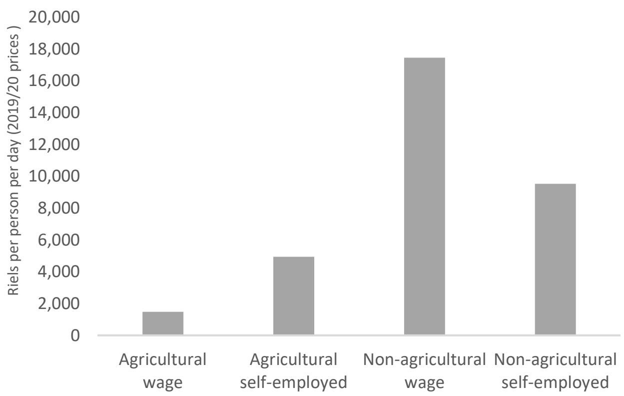
The employment profile of workers across income groups highlights the types of jobs poor workers in Cambodia hold. Poorer workers in Cambodia typically have low-wage, low-productivity occupations, such as farming, where earnings do not grow as quickly as those in higher-productivity occupations and sectors. This makes poorer workers more vulnerable to their incomes not keeping pace with inflation.

About half of the poorest workers in Cambodia are employed in the agriculture sector, where earnings have been, and still are, significantly lower than in nonagricultural sectors (figure S.6). Most better-off workers are employed in nonagricultural sectors, where earnings are at least twice as high. Historically, earnings in the agriculture sector have grown more slowly than in nonagricultural sectors. Comparing real earnings growth against inflation, it is evident that real agricultural earnings have increased at a rate more or less on par with inflation, while real nonagricultural earnings have increased at more than twice the rate of inflation, highlighting the slower growth of nominal wages in jobs largely held by the poor (figure S.8). As a consequence, sharp price increases are more likely to erode the real wages and assets of the poor to a greater extent than those of the rich (figure S.9). In the absence of more recent estimates of earnings covering the inflationary period, there is uncertainty as to whether agricultural earnings will be lagging, especially if the sale of own-produced food may benefit from higher prices.

Figure S.6: Decile-wise distribution of employment type

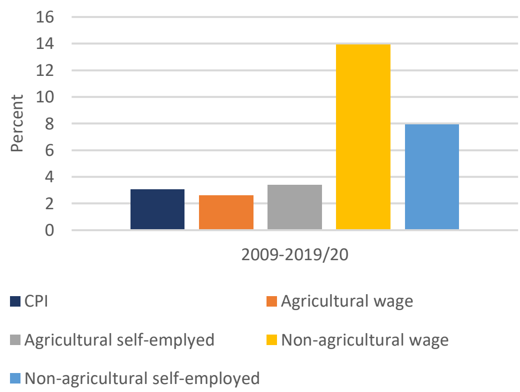
Source: World Bank staff calculations based on the CSES 2019/20.

Figure S.7: Real earnings, 2019/20



Source: World Bank staff calculations based on the CSES 2019/20.

Figure S.8: Annualized inflation and annualized real earnings growth by employment type, 2009–2019/20

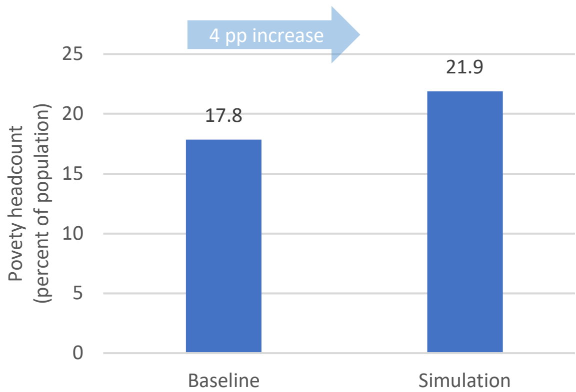


Source: World Bank staff calculations based on the CSES 2019/20 and CPI data.

Effects of inflation on poverty

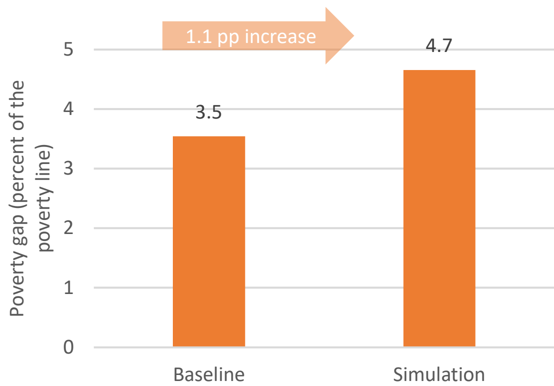
The simulation analysis suggests that inflation alone could increase poverty 4 percentage points from the national poverty rate of 17.8 percent, measured in 2019/20 (figure S.9).[28] The simulation analysis also suggests that the depth of poverty experienced by the population could increase, with the poverty gap increasing 1 percentage point, from 3.5 percent in 2019/20 (figure S.10).[29] Note, the simulated poverty rates reported reflect a basic measure of *felt* poverty or some concept of economic welfare loss rather than what *measured* poverty would be in 2022 (see Box S.2). These simulated impacts do not account for implications of COVID-19 or for the fiscal policy response implemented between 2020 and 2022 to support households, thus care must be taken when interpreting the results (see Box S.2).

Figure S.9: Poverty rate before and after inflation



Source: World Bank staff calculations based on the CSES 2019/20 and CPI data.

Figure S.10: Poverty gap before and after inflation



Source: World Bank staff calculations based on the CSES 2019/20 and CPI data.

[28] The headcount index measures the proportion of the population that is poor; that is, the proportion of the population whose income or consumption falls below the poverty line.

[29] The poverty gap index measures the extent to which individuals' income or consumption on average fall below the poverty line, expressed as a proportion of the poverty line.

Box S.2: Simulation methodology, assumptions, and caveats

To simulate the effects of inflation on poverty, we first estimate *household-specific* inflation rates from the time of survey to August 2022. To achieve this, we consider the household's consumption basket at the time of the survey and apply inflation rates that are specific to the categories of goods and services that the household consumes. Using the household-specific inflation rates, baseline expenditures are deflated in real terms to August 2022 to construct a counterfactual consumption aggregate. The simulated post-inflation poverty rates are then estimated using the national poverty line. See Annex S.2 for more details.

It is crucial to note that the simulated poverty rates reported in the Special Focus reflect a basic measure of *felt* poverty or some concept of economic welfare loss rather than what *measured* poverty would be in 2022. Caution must be exercised in interpreting the results because of the following limitations:

- Behavioral responses, such as the substitution of goods and dissaving to smooth consumption, are not modelled.
- General equilibrium effects are not considered (such as the multiplier effect of higher household incomes due to social assistance).
- Impacts of COVID-19 and the substantial fiscal response implemented during 2020-2022 are not included in the simulation.

For these reasons, especially the first one, measured poverty may have been lower than the estimates included here. Households may have switched to cheaper foods to get the same calories, increased income to compensate for higher prices through increased labor, or dipped into savings or borrowed from friends and family to maintain real consumption. While all of these responses may have reduced measured poverty impacts, they nonetheless have real costs: cheaper calories may have less micronutritional value, increased labor reduces leisure and may even come at the cost of children's education, dissaving or borrowing reduces a household's resilience and ability to cope with the next shock.

Source: Karamba, Myck, Trzcinski and Tong. (forthcoming).

Simulations of mitigation measures

What can be done about the fact that the poor are adversely affected by inflation? To answer that question, we simulate the impact of providing targeted social assistance to poor and vulnerable households in the form of cash transfers.

Cash transfers targeted to the poor on a national scale is relatively new to Cambodia. In 2019, cash transfers for pregnant women and children under age 2 were introduced, marking the first nationwide program although spending and coverage were small (Box S.3). During the pandemic, the government launched the "Cash Transfer Program for Poor and Vulnerable Households during COVID-19" (CTP-COVID). The program marked a significant and unprecedented scale-up in social assistance in terms of spending, scale of payments, and coverage (see Box S.3). The program partially mitigated welfare losses and food insecurity among families identified as poor in the IDPoor database.[30]

Based on the learnings from the implementation of the CTP-COVID, the government is currently working on expanding the IDPoor database beyond the poor families to include at-risk-households. This will allow for rapid inclusion of vulnerable households in the event of a shock. Additionally, the government is considering a follow-up relief program, targeted to at-risk households to mitigate the effects of high inflation.

[30] World Bank (forthcoming).

Box S.3: Social Assistance in Cambodia

Social assistance in Cambodia pre-COVID
Before the COVID-19 pandemic, social assistance was nascent in Cambodia, but it had some strong features that facilitated the quick expansion of assistance during the pandemic. Large-scale social assistance programs were lacking prior to 2019. Pre-2019 levels of social assistance were very low in global comparison—Cambodia spent around 0.09 percent of its GDP on social assistance. Initial social assistance programs were geared towards improving human capital and were mostly in the form of in-kind benefits.[a] The launch of the cash transfer for pregnant women and children under two years of age (CTP-PWYC) in June 2019 marked Cambodia's first nationwide cash transfer program and a positive step towards providing greater social assistance.

Social assistance during COVID
To respond to the COVID-19 shock, the government launched the "Cash Transfer Program for Poor and Vulnerable Households during COVID-19" (CTP-COVID). The program marked a significant scale up of social assistance spending and coverage. Spending on cash transfers rose from less than 0.1 percent of GDP in 2019 to 0.7 in 2020 and 1.4 in 2021. The program currently benefits nearly 700,000 households (or 20 percent of households) and has been extended through 2022. In 2019, only 2 percent of the households received the cash transfers through the program for pregnant women and children under two of age.

To rapidly deploy emergency cash assistance, the government leveraged the existing IDPoor database of identified poor families as well as the implementation and delivery arrangements of the CTP-PWYC. IDPoor is the country's official poverty identification and targeting mechanism used nationwide. The IDPoor program entitles families identified as poor access to range of services such as free health care and social transfers.

Other forms of government assistance during COVID
The cash transfer program was the largest component of the government's support package during the pandemic but not the only support. The government also introduced other measures to mitigate the adverse pandemic effects on the economy and households including but not limited to:[b]

- unemployment benefits for suspended workers in the tourism sector and in the garment, footwear and travel (GFT) goods sector;
- tax relief for the tourism and GFT goods sectors;
- retraining and upskilling programs for laid-off workers in tourism and GFT goods sectors;
- establishment of a new cash for work program targeting small infrastructure improvement projects;

The total fiscal cost of RGC's COVID-19 response amounted to US$823 million in 2020 and US$689 million in 2021.

Source: a. Shrestha, Palacios and Chavez (forthcoming). b. See World Bank (forthcoming) for details.

The scenarios presented here are hypothetical examples and do not reflect actions the government will take. Instead, the scenarios help to advance our understanding of how various forms of social assistance expansion could help the poor and most vulnerable. It is important to note that all scenarios are different potential targeted direct cash transfers, which have been a key component of the government's response to cushion the economic impacts of both the pandemic and current inflation on poorer households. In addition, they are far more effective and efficient than alternative policies, notably subsidies. The recent World Bank (2022d) flagship on fiscal policy during the COVID-19 recovery found that targeted transfers: (i) benefit the poor much more;[31] (ii) tend to have a larger impact on income growth than subsidies; (iii) can help households make crucial long-run investments—such as in educating children; and (iv) may also stimulate local economic activity and increase government revenue through higher indirect tax revenue in both the short and long run. Finally, the continued development of delivery systems for targeted social assistance can later facilitate broader tax reforms to generate more public revenues, as any burden of the

[31] One-half of all spending on energy subsidies in low- and middle-income economies goes to the richest 20 percent of the population, who consume more energy, while more than 60 percent of spending on cash transfers goes to the bottom 40 percent.

new taxes on poorer households is easily offset through the transfer system, costing just a fraction of the new revenues.

In the analysis we consider four scenarios.

(i) Beginning with a baseline scenario, a certain amount of cash is given to poor people registered in the IDPoor database. This scenario is in line with the action the government has taken during the pandemic to mitigate the negative effects on poor households (see Box S.3). For the purposes of the exercise, the benefit levels considered are those the government provided under the COVID-19 relief cash transfer program (see Annex S.3 for details).

(ii) We then consider a *vertical expansion* of the program, where we increase the benefit level to existing IDPoor beneficiaries. In the exercise, the benefit level is doubled, but other adjustments can also be explored.

(iii) We also consider a *horizontal expansion* of the program, where we expand the population coverage without expanding the benefit level. Coverage is expanded to households that are at-risk of falling into poverty in the aftermath of shocks. These households are defined as near poor[32] (those whose per capita consumption, as defined in the CSES, is between 1 time and 1.25 times the national poverty line) and have at least one of the following vulnerabilities: (a) at least one household member with a disability; (b) at least one household member below age 2; (c) at least one household member above age 60; (d) a single, female-headed household; and/or (e) all household members are below age 18.

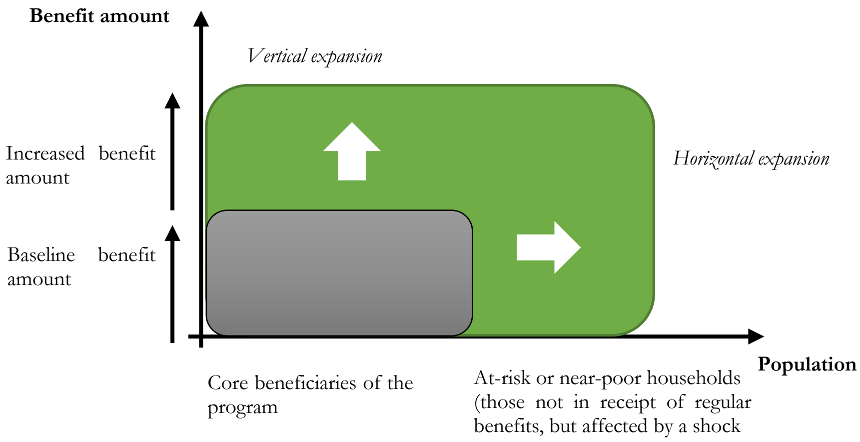
Note, at-risk households used in these scenarios are identified through simulations and are not necessarily the households that will be identified by the Commune/Sangkat Working Groups using the same mechanism and questionnaire that are used for the IDPoor Identification.

(iv) Finally, we consider a scenario that focuses on *expanding coverage to poor households* and enrolling them in the IDPoor program. These poor households (a) have per capita consumption that falls below the national poverty line and (b) are not enrolled in the IDPoor program. This scenario recognizes that poverty is dynamic in nature and not a static condition, and that households can fall in and out of poverty at various points in time.

Figure S.11 graphically illustrates these scenarios, with scenario 2 representing a vertical expansion of assistance, and scenarios 3 representing a horizontal expansion of assistance.

[32] Note, there is no official definition of "near-poor" in Cambodia. The proposed threshold of per capita consumption between 1 and 1.25 times the poverty line as well as between 1 and 1.5 times the poverty line are options considered by the government.

Figure S.11: Illustration of possible social assistance expansion



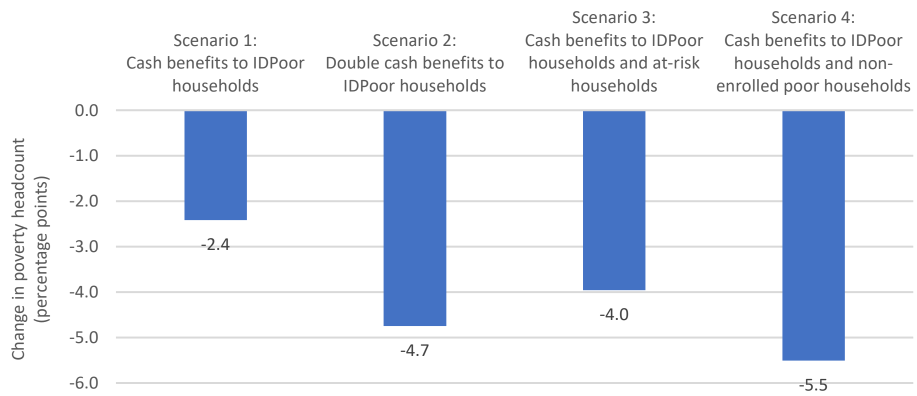
A temporary expansion of social cash assistance would mitigate poverty

A temporary expansion of social cash assistance would either moderate or fully mitigate the poverty impact of inflation depending on the scope of the intervention. Providing cash transfers to existing IDPoor beneficiaries at the benefit level of the CTP-COVID would mitigate about half of the poverty impacts of inflation while fully mitigating further deprivation (figure S.12). This approach is beneficial to protect the poor from further destitution, but leaves room for improvement in terms of adequacy and coverage.

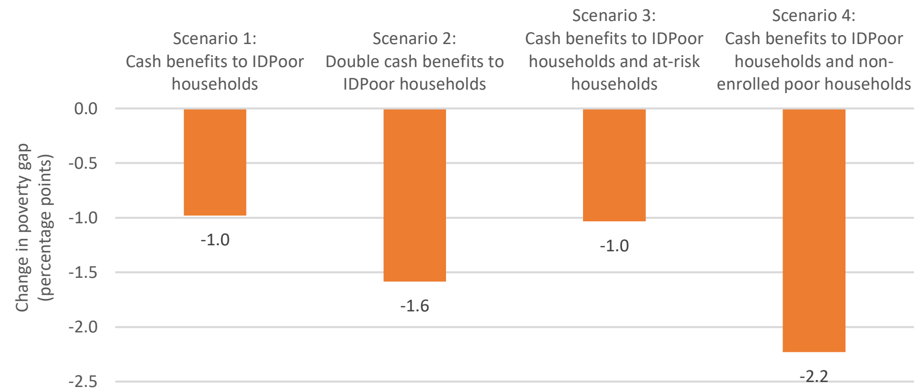
Expanding assistance, either through more generous benefits or greater population coverage, has potential for greater impact. Increasing the benefit level for existing IDPoor beneficiaries would help to further moderate the poverty impact of inflation, and would potentially lift people out of poverty depending on the level of generosity. Expanding the population coverage of the program to at-risk households also has the potential to fully mitigate the poverty impact of inflation. Finally, expanding coverage to poor households that may have recently fallen into poverty offers the greatest poverty mitigation.

Figure S.12: Simulated impact of income support on poverty

Panel A. Poverty mitigated through income support (simulation)



Panel B. Poverty depth mitigated through income support (simulation)



Source: World Bank staff calculations based on the CSES 2019/20 and CPI data.
Note: The benefit levels considered here are those provided under the COVID-19 relief cash transfer program. At-risk households are households that could fall into poverty per the authors' simulated identification process. These do not reflect households that will be identified by the Commune/Sangkat Working Groups using the same mechanism and questionnaire that are used for the IDPoor Identification.

A temporary expansion of social cash assistance would also reduce inequality. Because simulated effects of inflation on inequality as measured by the Gini coefficient were negligible (see figure S.13), providing income support to poor and vulnerable households would reduce inequality from the baseline by between 0.9 percentage points and 1.6 percentage points. While inequality in Cambodia is moderate in international comparison, it must, however, be monitored in light of the uneven household impacts of the pandemic and uneven economic recovery.

What will it cost?

What policy approach could be taken? This will depend on the goal to be achieved and the resources available, especially when fiscal tightening may be necessary. In this section, we evaluate the impact, cost, and cost-effectiveness of each scenario to compare one intervention against another.

Looking purely at the impact of interventions, continued expansions of assistance to poor households offers substantial poverty and inequality reduction. At the same time, this may require more resources than other options. To facilitate the comparison of interventions, we look at cost-effectiveness, which combines the cost and the outcome to evaluate how much it costs to gain a unit of poverty or inequality reduction (table S.1). Expanding the program to "newly poor" households (scenario 4) would be most cost-effective in mitigating poverty and deeper deprivation. In other words, it costs less to gain an additional percentage point reduction in poverty than other interventions. Expanding the program to at-risk households (scenario 3) offers the second most cost-effective way to mitigating poverty and deeper deprivation. While increasing the benefit level is more costly, it does provide substantial poverty alleviating benefits. Moreover, all four scenarios can be implemented in a temporary manner. For example, an initial one-off payment of three months could be made while the ongoing severity of inflation monitored to determine whether additional payments will alter be necessary (most countries using cash transfers have adopted this approach in responding to inflation; Gentilini et al. 2022). In this case, the fiscal cost is initially significantly lower (as indicated in the far right quarterly column of the table) and is around the same or less than the government is currently spending on energy subsidies.

Table S.1: Impact, cost and cost-effectiveness of mitigation measures

	Change in poverty headcount (percentage points)	Change in poverty gap (percentage points)	Change in Gini (percentage points)	Budget (US$ millions, annual)	Cost-effectiveness of poverty alleviation (US$ millions per point reduced)	Cost-effectiveness of poverty depth alleviation (US$ millions per point reduced)	Cost-effectiveness of inequality reduction (US$ millions per point reduced)	Budget (% of GDP, annual)	Budget (% of GDP, quarterly)
Impact on inflation	4.0	1.1	0.0	-					
Scenario 1: Cash benefits to IDPoor households	-2.4	-1.0	-0.9	430	178	439	475	1.6	0.4
Scenario 2: Double cash benefits to IDPoor households	-4.7	-1.6	-1.6	861	181	543	545	3.1	0.8
Scenario 3: Cash benefits to IDPoor households and at-risk households	-4.0	-1.0	-1.3	575	145	557	444	2.1	0.5
Scenario 4: Cash benefits to IDPoor households and non-enrolled poor households	-5.5	-2.2	-1.7	647	117	290	370	2.4	0.6

Note: The benefit levels considered are those provided under the COVID-19 relief cash transfer program.

Conclusion and policy implications

How should policy be designed to reduce the impact of the inflation shock on the poor? The following section discusses policy options to address the negative impacts of the food and oil price shock.

First, it is crucial to protect the poor and vulnerable through a well-targeted and temporary expansion of social protection programs. Hence, it will be beneficial to:

- Continue to provide targeted income support to poor households, to ensure support is directed to those most in need and to maximize value for money.
- If resources allow, adjust the benefit level up to offset welfare losses until inflation is down.
- Strengthen the social protection system to be able to dynamically identify shock-affected households during times of crisis and expand social assistance coverage to households at-risk of falling into poverty.

Second, it is crucial to protect resources allocated to social safety nets and social services, especially when fiscal tightening may be necessary. Human capital is often the only asset the poor have to generate income and improve their quality of life; hence, it is imperative to protect the income of poor households from income shocks, and to protect access to services, especially education and health care, that build their human capital and future earning potential. At the same time, the COVID-19 pandemic caused fiscal deficits to rise to 4.3 and 5.7 percent of GDP in 2020 and 2021, respectively, as lower economic activity and pandemic-related tax relief reduced total revenues, while total expenditures increased under the Government's fiscal response program (which included subsidies and transfers, amounting to 2.9 percent of GDP in 2020). The fiscal deficit is projected to widen further in 2022 before narrowing in 2023–2024. While fiscal buffers remain relatively robust, increased attention to fiscal sustainability and resilience will be required to navigate the period ahead.

This may require some tradeoffs such as prioritizing temporary targeted income support to poor and vulnerable groups over, for example, energy subsidies or value-added tax (VAT) exemptions on food. Targeted cash transfers at a scale large enough to compensate for welfare losses is a more efficient way to deliver net benefits to poor and vulnerable households. This is because essentially everyone benefits from the subsidies or food tax exemptions, not just the poor. This implies much less efficient targeting of resources. In many cases, energy subsidies and exemptions can also be regressive as better-off households tend to consume higher shares of energy and spend more money on food, even if that amount represents a smaller share of their overall budget. In some scenarios, supporting households through subsidies and tax exemptions might have additional benefits, but faced with limited resources, the targeting of relief programs will be crucial for delivery of desired outcomes.

Finally, it would be beneficial to monitor inflation at a more spatially granular level to better understand the effects of inflation spatially, especially in rural areas where most of the poor reside. This would require strengthening price data collection in more remote parts of the country.

Annex S.1: Data

To simulate the impact of inflation on welfare and poverty, we combine household expenditure data from the Cambodia Socio-Economic Survey (CSES) with monthly Consumer Price Index (CPI) data for Phnom Penh. These data are collected and compiled by the National Institute of Statistics of Cambodia (NIS) under the Ministry of Planning.

The CSES 2019/20 was conducted between July 2019 and June 2020 and collects expenditure information on 64 food items and 40 non-food categories.

The CPI aggregates price data from 258 items, of which 100 are food items and the 158 are non-food items. The Laspeyres formula is used to compute CPIs using weights from the CSES. These items are grouped into 12 main categories according to the Classification of Individual Consumption According to Purpose (COICOP), and include (1) Food and Non-Alcoholic Beverages; (2) Alcoholic Beverages, Tobacco, and Narcotics; (3) Clothing and Footwear; (4) Housing, Water, Electricity, Gas, and Other Fuels; (5) Furnishings, Household Equipment, and Routine Maintenance; (6) Health; (7) Transport; (8) Communication; (9) Recreation and Culture; (10) Education; (11) Restaurants and Hotels; and (12) Miscellaneous Goods and Services.

Both the CPI and CSES use the same COIOP categories. Nine categories in the CSES are matched to the CPI categories, excluding alcoholic beverages, restaurants and hotels, and miscellaneous goods and services.

Annex S.2: Methodology

Inflation inequality over time

To estimate the monthly *decile-specific inflation* trends from the time of survey, we begin by estimating the monthly *household-specific inflation rate.* Year-on-year inflation rates for each category of goods and services (item-specific y/y inflation rates) are constructed for each month from time of survey (July 2019–June 2022) until August 2022. The *household-specific inflation rate* for each month is calculated as the weighted sum of the monthly y/y inflation rate of goods and services the household consumes, grouped into 10 categories (where we isolate fuel as an independent category). The equation is as follows:

$$\pi_{hmt} = \sum_{c=1}^{c=10} S_{hcmt} * \pi_{cmt} \qquad (1)$$

where π_{hmt} is the y/y inflation rate for household *h*, in month *m* and year *t*. C (=1,….,10) represents the 10 categories, and *S* is the share of each COICOP category *c* for household *h* in month *m* and year *t*.

The *decile-specific inflation rate* for each month is calculated as the weighted average of the household-specific inflation rates for all households in that decile. Households are sorted in their specific decile based on per capita market (pre-fiscal income). The deciles are adjusted for population weights. The equation is as follows:

$$\pi_{dmt} = \frac{1}{N_d} \sum_{1}^{N_d} \pi_{hmt} \qquad (2)$$

where *d* (=1…10) represents deciles, and N is the total number of households in each decile.

Finally, the *decile-specific inflation rate 0* is calculated using formula (2) while only accounting for goods and services within that category.

We use certain assumptions in the calculation of decile-wise inflation rates. First, we assume that the composition of the consumption basket remained constant during this period. Second, we differentiate between purchased and home-produced consumption items, only inflating the purchased consumption items to avoid overestimating inflation rates for households that consume more home-produced food items as a share of their total food consumption, such as rural households. Finally, the calculations assume a zero elasticity between consumption and income growth, which implies that the composition of household consumption expenditure remains unchanged as incomes rise or decline.

Decile-specific inflation cost as of August 2022

To evaluate the *cumulative decile-specific inflation* cost to households from time of survey to August 2022, we begin by estimating the *cumulative household specific inflation rate*. We estimate the *cumulative item-specific inflation rate* from time of survey and August 2022. Then the *cumulative household-specific inflation rate* is calculated as the weighted sum of the *item-specific inflation rate*. The *decile-specific inflation rate* for the period between time of survey and August 2022 is calculated as the weighted average of the household-specific inflation rates for all households in that decile.

Annex S.3: Relief cash transfer benefits for poor and vulnerable households during COVID-19

Table S.2: Relief cash transfer program benefits for poor and vulnerable households during COVID-19 (US$)

	Phnom Penh		Other urban		Other rural	
	IDPoor 1	**IDPoor 2**	**IDPoor 1**	**IDPoor 2**	**IDPoor 1**	**IDPoor 2**
Household	$30	$30	$30	$30	$20	$20
Each member	$13	$9	$10	$7	$6	$4
Vulnerable member						
Child aged 0–5	$10	$7	$10	$7	$6	$4
Disability	$10	$7	$10	$7	$6	$4
Adult aged 60+	$10	$7	$10	$7	$6	$4
HIV/AIDS	$10	$7	$10	$7	$6	$4

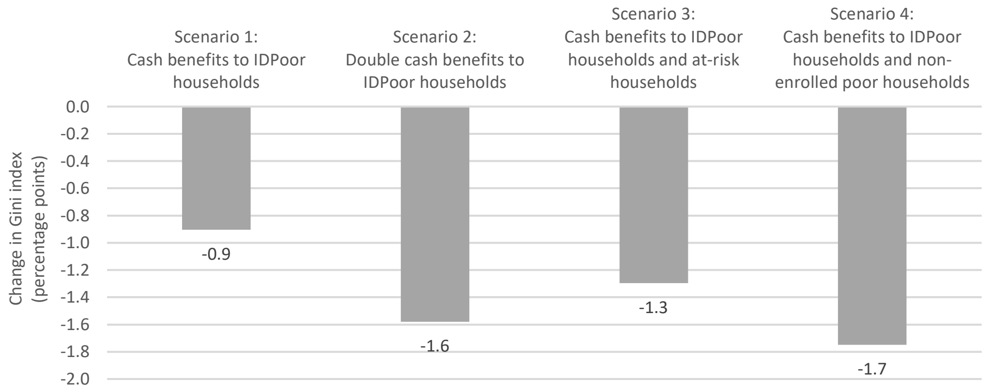
Source: Ministry of Planning.

Annex S.4: Additional figures and tables

Figure S.13: Gini index before and after inflation

Source: World Bank staff calculations based on the CSES 2019/20 and CPI data.

Figure S.14: Inequality reduced through income support (simulation)



Source: World Bank staff calculations based on the CSES 2019/20 and CPI data.
Note: The benefit levels considered here are those provided under the COVID-19 relief cash transfer program. At-risk households are households that could fall into poverty per the authors' simulated identification process. These do not reflect households that will be identified by the Commune/Sangkat Working Groups using the same mechanism and questionnaire that are used for the IDPoor Identification.

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Annex 1: Cambodia - Selected Indicators

SELECTED INDICATORS*	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022 E
INCOME AND ECONOMIC GROWTH															
GDP growth (annual %)	6.7	0.1	6.1	7.1	7.3	7.4	7.1	7.0	6.9	7.0	7.5	7.1	-3.1	3.0	4.8
GDP per capita growth (annual %, real)	5.1	-1.4	4.5	5.4	5.6	5.6	5.4	5.3	5.3	5.4	5.9	5.5	-4.4	1.6	3.4
GDP per capita (US$, nominal)	744.5	737.9	812.9	891.6	949.8	1028.2	1100.5	1175.3	1269.8	1381.4	1506.2	1638.1	1552.2	1616.9	1758.5
Private Consumption growth (annual %)	12.7	-0.2	8.8	10.4	4.7	5.6	4.6	9.4	5.8	3.7	3.0	7.0	-0.8	10.9	-8.3
Gross Investment (% of nominal GDP)	17.3	20.1	16.2	16.0	17.4	18.7	20.9	21.4	21.7	21.9	22.6	23.4	23.6	36.2	30.2
Gross Investment - Public (% of nominal GDP)[2]	6.3	8.8	9.6	10.7	9.1	9.1	8.2	6.9	6.7	6.8	6.7	7.7	8.6	7.0	7.6
MONEY AND PRICES															
Inflation, consumer prices (annual %, EOP or MRV)[1,3]	12.5	5.1	2.9	4.6	2.3	4.5	0.9	2.8	3.8	2.1	1.5	3.0	2.8	3.7	7.8
Inflation, consumer prices (annual %, period average)[3]	12.3	3.1	2.6	5.5	3.0	2.9	3.9	1.2	3.0	2.9	2.5	1.9	2.9	2.8	6.0
Broad Money (% of GDP)[2]	28.3	37.7	41.6	39.1	50.1	55.5	67.1	72.4	79.2	88.2	100.7	116.4	137.3	150.1	171.7
Domestic Credit to the Private Sector (% of GDP)[2]	23.5	24.6	27.6	28.3	38.7	52.0	62.7	74.3	81.7	86.7	99.6	114.2	139.6	150.4	164.7
10 year interest rate (annual average)[3]	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Nominal Exchange Rate (local currency per USD)	4060.0	4140.0	4044.0	4016.0	4033.0	4027.0	4030.0	4025.0	4058.0	4062.0	4067.0	4070.0	4077.4	4100.0	4150.0
Real Exchange Rate Index (2015=100)	91.5	91.0	98.2	94.4	93.3	92.6	94.7	100.0	101.9	103.2	99.6	109.1	99.6	105.5	108.3
FISCAL															
Revenue (% of GDP)	16.4	15.9	17.7	17.6	17.7	18.2	20.0	19.7	20.9	21.9	23.8	27.0	23.9	22.0	22.7
Expenditure (% of GDP)	16.1	20.5	21.0	23.0	21.9	21.4	21.9	20.2	21.1	22.7	23.4	25.5	28.8	29.6	27.3
Interest Payments (% of GDP)	0.2	0.2	0.3	0.3	0.5	0.7	0.7	0.3	0.4	0.4	0.4	0.4	0.6	0.5	0.5
Non-Interest Expenditure (% of GDP)	15.9	20.3	20.7	22.7	21.4	20.7	21.2	19.9	20.7	22.3	23.0	25.1	28.2	29.1	26.8
Overall Fiscal Balance (% of GDP)	0.3	-4.6	-3.3	-5.4	-4.2	-3.2	-1.9	-0.5	-0.2	-0.8	0.4	1.5	-4.9	-7.6	-4.6
Primary Fiscal Balance (% of GDP)	0.5	-4.4	-3.0	-5.1	-3.7	-2.5	-1.2	-0.2	0.2	-0.4	0.8	1.9	-4.3	-7.1	-4.1
General Government Debt (% of GDP)	27.8	29.1	28.7	29.7	31.6	31.3	31.8	31.2	29.1	30.3	28.3	28.2	32.7	34.7	36.7
EXTERNAL ACCOUNTS															
Export growth, G&S (nominal US$, annual %)	20.2	-24.4	22.9	11.4	16.0	16.8	10.3	7.5	9.0	9.4	12.3	8.5	2.1	11.2	24.9
Import growth, G&S (nominal US$, annual %)	11.3	-17.0	19.1	11.4	14.2	16.9	8.8	7.6	9.0	7.8	9.3	17.4	5.7	46.1	1.3
Merchandise exports (% of GDP)	49.4	33.9	38.3	38.8	41.6	44.6	45.4	45.4	45.5	45.2	46.0	46.0	51.9	61.8	69.0
Merchandise imports (% of GDP)	58.2	46.8	50.4	50.5	53.7	57.5	57.5	57.3	56.9	55.6	55.1	54.6	65.8	90.9	89.8
Services, net (% of GDP)	6.5	6.2	6.8	6.3	7.3	7.8	7.7	7.5	7.0	7.0	7.4	1.8	4.1	-5.7	3.2
Current account balance (current US$ millions)	-622.3	-1120.4	-1165.3	-1309.3	-1390.7	-1489.3	-1899.7	-1680.6	-1756.6	-2140.5	-2180.1	-4107.7	-3221.0	-11492.8	-7549.1
Current account balance (% of GDP)	-6.0	-10.8	-10.0	-10.1	-9.9	-9.6	-11.3	-9.2	-8.8	-9.7	-8.9	-15.2	-12.4	-41.9	-25.0
Foreign Direct Investment, net inflows (% of GDP)	7.6	8.8	11.8	11.8	14.0	13.0	10.6	9.5	12.0	12.1	12.6	13.2	13.5	12.4	12.4
External debt, total (% of GDP)[2]	25.6	31.8	35.7	36.3	48.0	50.0	49.8	52.3	50.3	51.5	55.1	56.6	67.9	..	..
Multilateral debt (% of total external debt)[2]	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Debt service ratio (% of exports goods and non-factor services)[2]	0.8	1.0	1.1	4.0	6.0	5.7	5.4	5.1	5.1	6.2	6.7	6.9	7.1	..	..
POPULATION, EMPLOYMENT AND POVERTY															
Population, total (millions)	13.9	14.1	14.3	14.5	14.8	15.0	15.3	15.5	15.8	16.0	16.2	16.5	16.7	16.9	17.2
Population Growth (annual %)	1.5	1.5	1.6	1.6	1.6	1.7	1.7	1.6	1.6	1.5	1.5	1.5	1.4	1.4	1.3
Unemployment Rate[2]	0.8	0.6	0.8	0.6	0.5	0.4	0.7	0.4	0.7	0.1	0.1	0.1	0.3	0.6	..
Inequality - Gini Coefficient[2]	..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Life Expectancy[2]	65.4	66.0	66.6	67.0	67.5	67.9	68.3	68.6	69.0	69.3	69.6	69.8	70.1	..	..
OTHER															
GDP (current LCU, millions)	41968385.0	43056732.0	47047985.0	52068693.0	56616800.0	62219524.0	67740436.0	73,422,702	81,241,866	89,830,525	99,544,275	109,916,799	109,718,043	122,138,585	136,425,846
GDP (current US$, millions)	10337.0	10400.2	11634.0	12965.3	14038.4	15450.6	16809.0	18,242	20,020	22,115	24,476	27,007	25,950	27,400	30,171
GDP per capita LCU (real)	2062211.4	2033232.2	2124293.2	2238619.2	2363486.0	2495840.9	2630659.9	2,769,140	2,915,146	3,071,748	3,252,348	3,431,774	3,279,159	3,332,285	3,447,204
Human Development Index Ranking[4]	142	142	143	143	145	144	144	146	146	145	144	144	..	..	..
CPIA (overall rating)[2]	3.3	3.3	3.4	3.4	3.5	3.4	3.4	3.4	3.4	3.4	3.4	3.4	3.4	..	..
Economic Management[2]	3.8	3.8	4.0	3.8	3.8	3.8	3.8	4.0	4.0	4.0	4.2	4.2	4.2	..	..
Structural Policies[2]	3.3	3.3	3.3	3.5	3.7	3.7	3.7	3.5	3.5	3.3	3.3	3.3	3.3	..	..
Policies for Social Inclusion and Equity[2]	3.3	3.3	3.4	3.5	3.5	3.4	3.4	3.4	3.4	3.4	3.4	3.5	3.5	..	..
Public Sector Management and Institutions[2]	2.7	2.7	2.7	2.8	2.8	2.8	2.8	2.7	2.7	2.7	2.6	2.6	2.7	..	..

Notes: ".." indicates not available. E = estimate, F = forecast. Data from MFMOD unless otherwise noted.
1/ Used latest month available.
2/ World Development Indicators Database and World Bank Staff Estimates
3/ World Bank GEM database; MRV = Most recent value
4/ The HDI ranking in 2001 is in relation to 175 countries and in 2010 in relation to 169 countries. Methodological enhancements in HDI calculations have resulted in notable improvements in the countries' rankings.

Sources: MFMOD Database, World Bank WDI and GEM databases, IMF.

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