

PERSPECTIVE

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Cambodia's Post-Pandemic Recovery and Future Growth: Key Challenges

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The Buddhist Institute building, situated next to modern commercial buildings, in Phnom Penh on 29 June 2020. Photo: Tang Chhin Sothy, AFP.

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EXECUTIVE SUMMARY

- Almost two years after the pandemic, Cambodia is moving ahead with re-opening. An impressive vaccination campaign and pragmatic economic policies have helped position the country for economic recovery.
- However, risks remain and three key challenges must be addressed to support recovery and long-term growth.
- The first challenge relates to maintaining health security and the need to strengthen the healthcare system. Had there been more healthcare capacity, a more targeted approach in managing the outbreak would have been feasible, reducing the toll on the economy and livelihoods.
- Second is supporting new sources of growth. With the construction and real estate boom ending, future growth must come from diversification within agriculture and manufacturing, with a move towards higher value-added activities. A revival in tourism will aid recovery but will need to cater to higher-spending tourists.
- The last challenge relates to managing financial sector risks. The forbearance measures related to the pandemic and growth slowdown have increased the indebtedness of banks and households. While a gradual winding back may avert a financial meltdown, increased regulation and supervision are required for long term financial sustainability.

INTRODUCTION

Cambodia was one of the first countries in Asia to record a case of COVID-19 and was also heavily impacted by the pandemic. Two years later, it is moving ahead with re-opening. An impressive vaccination campaign and pragmatic economic policies have helped position the country for economic recovery. However, risks remain. This brief summarizes developments in 2020-2021 and highlights three key issues in support of recovery and long-term growth.

Strict border controls helped Cambodia avoid widespread transmission of COVID-19 during 2020, but this changed in February 2021 with a major outbreak in Phnom Penh. The disease quickly spread to all provinces of the country, triggering school closures, lockdowns, and other measures to slow transmission of the virus. For most of 2021, Cambodia was in a race between the vaccine and the virus. Vaccination began in January 2021 with donations of Sinopharm vaccines from China, and accelerated through the year as the government leveraged bilateral ties to secure additional vaccine supplies. Clear public communication, a rapid expansion of vaccination to include younger children, and a pragmatic area-based approach to vaccine rollout all contributed to an exceptionally quick vaccine rollout.

Cambodia recorded its first case of the Omicron variant in December 2021. This new variant spread rapidly, with the 7-day moving average reaching 550 cases in late February 2022 before a change in testing protocols brought reported case numbers down. Despite this threat, economic activity has continued to recover. Mobility, which is a good short-term proxy for economic activity, had largely returned to pre-pandemic levels by the end of 2021 and has not been severely impacted by the spread of Omicron. Flight connectivity and international visitor arrivals also started to improve, albeit from a low base.

These developments have positioned the economy for recovery in 2022, with the IMF forecasting growth of 5.1 per cent for the year, following a contraction of 3.1 per cent in 2020 and estimated growth of 2.1 per cent in 2021 (IMF, 2021a). This return to growth is encouraging, but the recovery remains fragile. In 2022 and beyond, policy makers will need to address three key challenges to safeguard the recovery: (i) maintaining health security; (ii) supporting new sources of growth; and (iii) managing financial sector risks.

Challenge No. 1 – Improving health surveillance and healthcare capacity

Although the COVID-19 pandemic is not yet over, it is clear that poor countries in particular need to be better prepared for future health and related crises, which are likely to become more frequent.

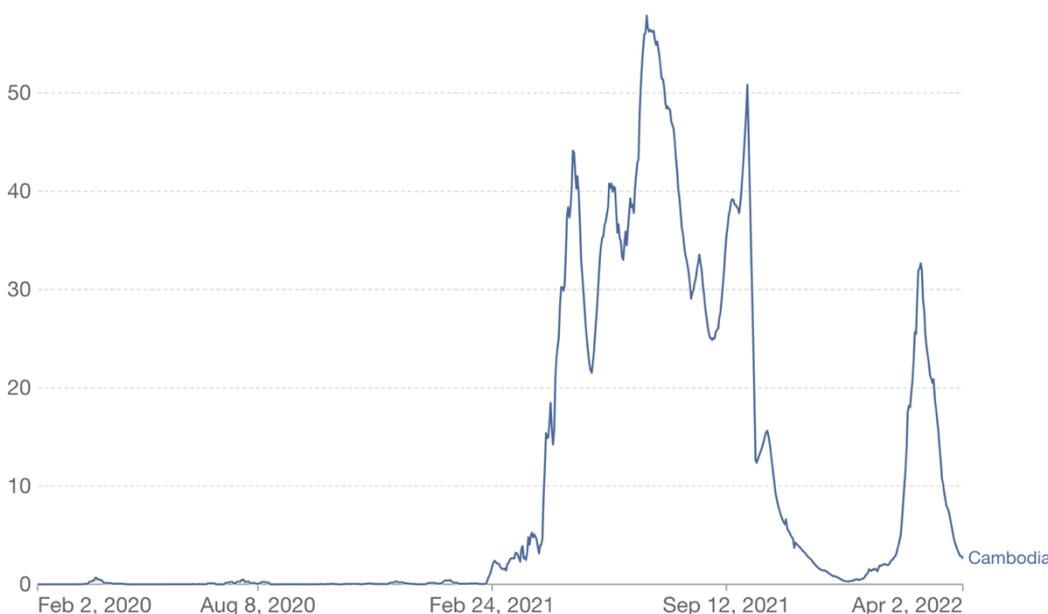
Cambodia recorded its sharpest daily decline of COVID-19 cases when they fell from 978 on 30 September to 232 on 1 October 2021 (Figure 1). The overnight reduction of 76 per cent was due to a change in the approach taken on testing. By eliminating random testing of asymptomatic individuals, the reported numbers now only reflected cases presented for testing following the onset of symptoms.

With the sharp drop in testing, case numbers remained predictably low for some time, leading to the easing of lockdowns and the opening of borders in November 2021. So, is this approach to ending the pandemic illusionary or visionary? The answer depends on whether it is time to redefine the pandemic by changing how it is measured. In other words, do circumstances warrant a shift in focus from infection rates to hospitalisation rates? This in turn depends on vaccination rates on the one hand, and the capacity and quality of the healthcare system on the other.

Figure 1

Daily new confirmed COVID-19 cases per million people

7-day rolling average. Due to limited testing, the number of confirmed cases is lower than the true number of infections.



Source: Johns Hopkins University CSSE COVID-19 Data

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As noted, Cambodia’s record on vaccinations has been remarkable. The vaccination rate in February 2022 at above 80 per cent of its population is one of the world’s highest with the WHO reporting that 99.0% of all adults have received two vaccine doses (WHO, 2022a). The government has also been proactive in expanding vaccine coverage to children and offering booster doses from different manufacturers to increase immune response. As a result, over 80 per cent of the population were fully vaccinated by March 2022, and population-level immunity continues to improve.

Although adequate supplies of vaccines from China and other partners were important in the vaccination outcome, Cambodia deserves credit for managing the logistics efficiently, enabling a rapid rollout under challenging circumstances. Work to strengthen vaccine supply chains has continued and the government has expanded its cold-chain infrastructure to enable nationwide rollout of mRNA vaccines for booster doses and vaccination of young children.

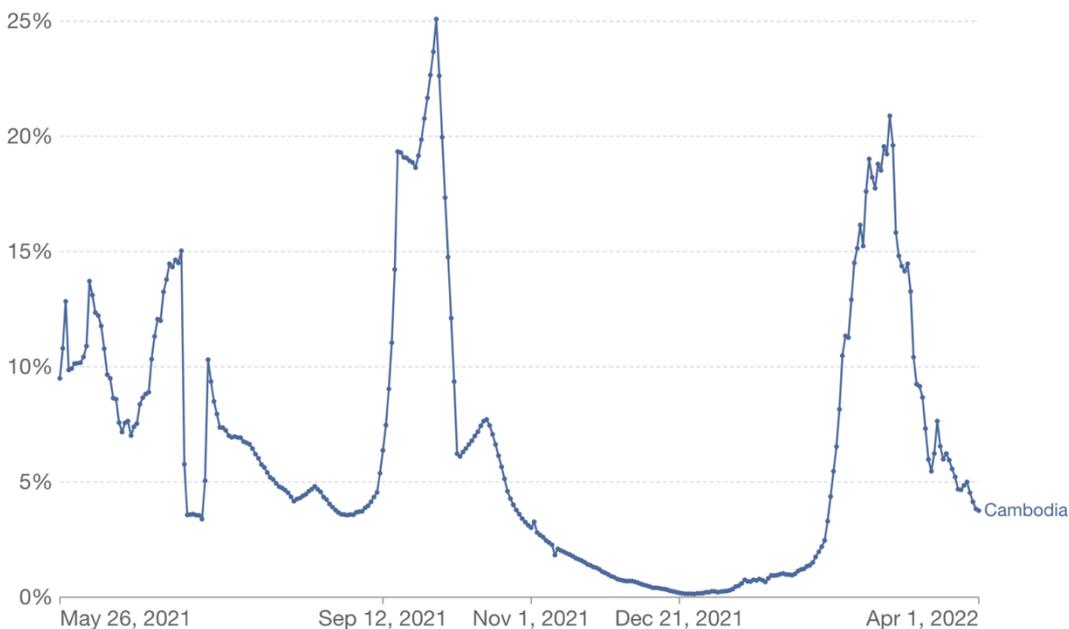
Despite these ongoing investments, Cambodia’s health system capacity remains among the lowest in Asia. For instance, there are currently only 0.7 hospital beds per 1,000 people, compared to 2.6 in Vietnam and an average 4.7 amongst the OECD countries. This suggests that a future surge in cases of a new COVID-19 variant requiring hospitalisation could quickly overwhelm the healthcare system. So, how does the decision to drastically reduce testing affect this risk?

Reduced testing makes the case positivity rate – the share of tests returning a positive result – less useful. Apart from being an indicator of the adequacy of testing itself, it can also be used to monitor the outbreak and introduce pre-emptive measures. The rate fell from 12.8% on 28 May 2022 to 7.0% on 19 June, presumably due to the lockdown.¹ However, subsequent reductions, including the sharp decline in October 2021 and March 2022 were driven by changes in testing policies

Figure 2

The share of daily COVID-19 tests that are positive

7-day rolling average. The number of confirmed cases divided by the number of tests, expressed as a percentage. Comparisons across countries are affected by differences in testing policies and reporting methods.



Source: Official data collated by Our World in Data

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Re-opening while reducing domestic health surveillance like testing could backfire if emerging signs of an outbreak that could overwhelm the healthcare system are missed as a result (see Menon, 2021a). This converts risk, where the probability of occurrence can be estimated, into uncertainty, where it cannot. The early warning system should therefore be retained and strengthened. The recent increase in cases in Cambodia due to transmission of the Omicron variant, is testimony to the need for continued, effective surveillance. The recent return of healthcare system stresses as a result of Omicron in Hong Kong and South Korea highlights this concern.

With limited healthcare capacity, Cambodia will have to rely on the efficacy of its extensive vaccination programme, consisting mainly of *Sinovac*, with booster doses of *AstraZeneca* and *Pfizer*. The biggest threat to this approach is the emergence of a new variant that significantly erodes the efficacy of current vaccines in preventing severe disease. This is one of the three scenarios that the WHO (2022b) recently outlined on how the pandemic could evolve in 2022. They warn that in a worst-case scenario, a more virulent and highly transmissible variant that overcomes protection from prior vaccination or infection could result in sudden increases in severe disease and death, especially if early warning systems have been downgraded or disabled. Since the evidence suggests that border closures cannot keep new variants out, mitigation measures through improved surveillance and healthcare systems are the only safeguard (see Menon, 2021b).

The key lesson from the pandemic is the need to increase both the quality and availability of health services. Cambodia had been falling behind on many of its Sustainable Development Goals (SDGs) before the pandemic (see Sachs *et al.*, 2021), leaving it vulnerable and exacerbating the negative social impacts of the pandemic. The universal health coverage indicator of SDG 3 on Health and Wellbeing measures the average coverage of essential services for prevention and treatment of infectious and non-communicable diseases for the general and the most disadvantaged population. The score of 60 out of 100 in 2017 (see Sachs *et al.*, 2021) means that Cambodia was not on-track to achieve its 2030 goals. The pandemic is a further setback in meeting the 2030 goals but the greater awareness of the importance of health system strengthening and the experience mobilizing additional resources for healthcare and social protection during the pandemic may help create momentum for Cambodia to catch up.

Challenge No. 2 – Sustaining future growth

While the economy is projected to return to positive growth in 2021 and pick up further in 2022, long-term growth will depend on public policy choices. To achieve the high rates of growth seen before the pandemic, Cambodia will need to implement a well-targeted programme of investments and reforms.

During 2010-2019, Cambodia's economy grew by more than 7 per cent per annum on average, making it one of the fastest growing countries in the world. This growth was initially fueled by large inflows of foreign direct investment (FDI), strong growth in garment manufacturing and tourism, and rural-urban migration of workers from agriculture into manufacturing and services. However, over time the sources of growth shifted to become increasingly reliant on construction and real estate, which was unsustainable. Property development boomed as investors sought to capitalize on rising urbanization, strong demand from foreign buyers, and the development of Sihanoukville as a hub for gambling and coastal tourism.

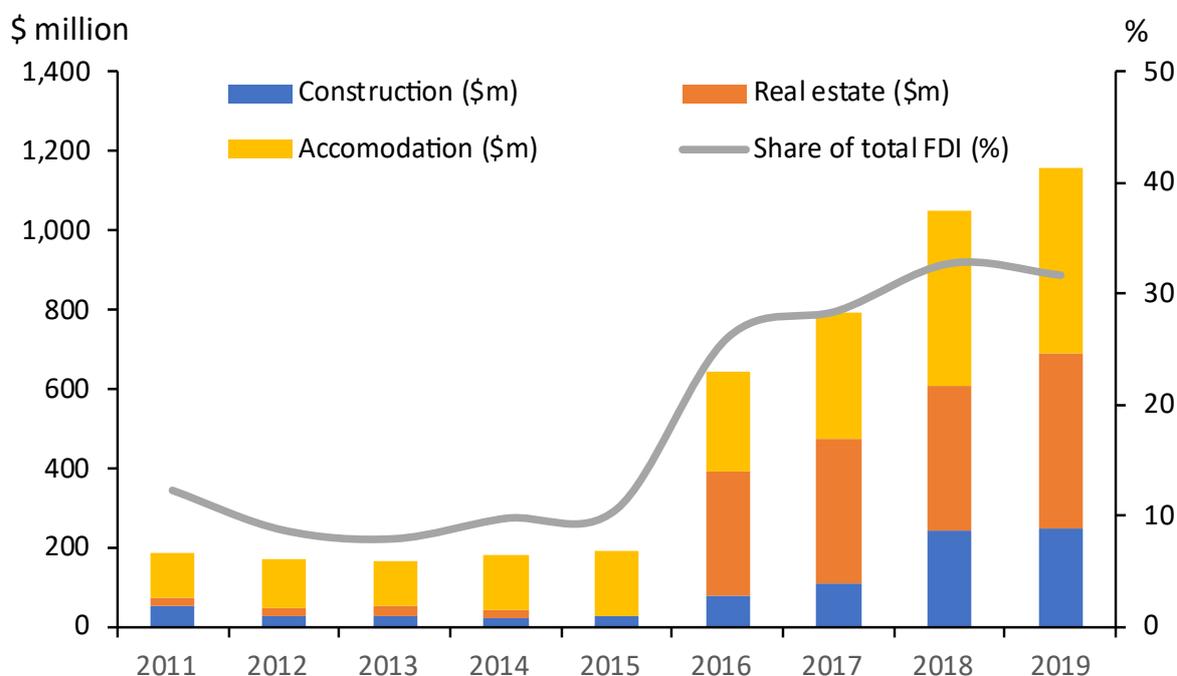
The construction and real estate sectors accounted for 19.0 per cent of all growth in 2010-2019 and accounted for 22.5 per cent of total GDP in 2019 (Figure 3). Having accounted for only 4.8 per cent of FDI inflows in 2011, FDI into construction increased steadily to reach 18.8 per cent in 2019. While prices for residential and commercial property remained

below regional comparators, the investment boom led to a growing problem of over-supply that has been exacerbated by reduced demand due to COVID-19.

The construction and real-estate sectors cooled significantly in 2020-2021. The close linkages between construction, real-estate, and the financial sector mean that further corrections in the property market could spill over to the rest of the economy. Even if the property and real-estate sector can achieve a soft landing, it is unlikely to be a major source of growth in the medium term. Cambodia will therefore need to rely on productivity improvement and upgrading of agriculture, manufacturing, and other services as the main drivers of growth going forward. Achieving this will require continued investments in infrastructure and human resources as well as reforms to reduce transaction costs and facilitate private investment.

Significant investments are already underway to improve competitiveness. The Phnom Penh-Sihanoukville expressway, which will halve travel time between the two cities, is due to be completed in 2022, while construction of new airports to serve Phnom Penh and Siem Reap is progressing well. The government has also implemented reforms to reduce the cost of doing business. An online business registration service was launched in 2020, followed by an online licensing platform and a new investment law in 2021. The new investment law includes enhanced incentives to stimulate skills development and investment in high-tech industries, but it will not become fully effective until implementing regulations have been approved.

Figure 3.
FDI inflows to construction, real estate, and accommodation (\$ million), and as a share of total FDI (%)



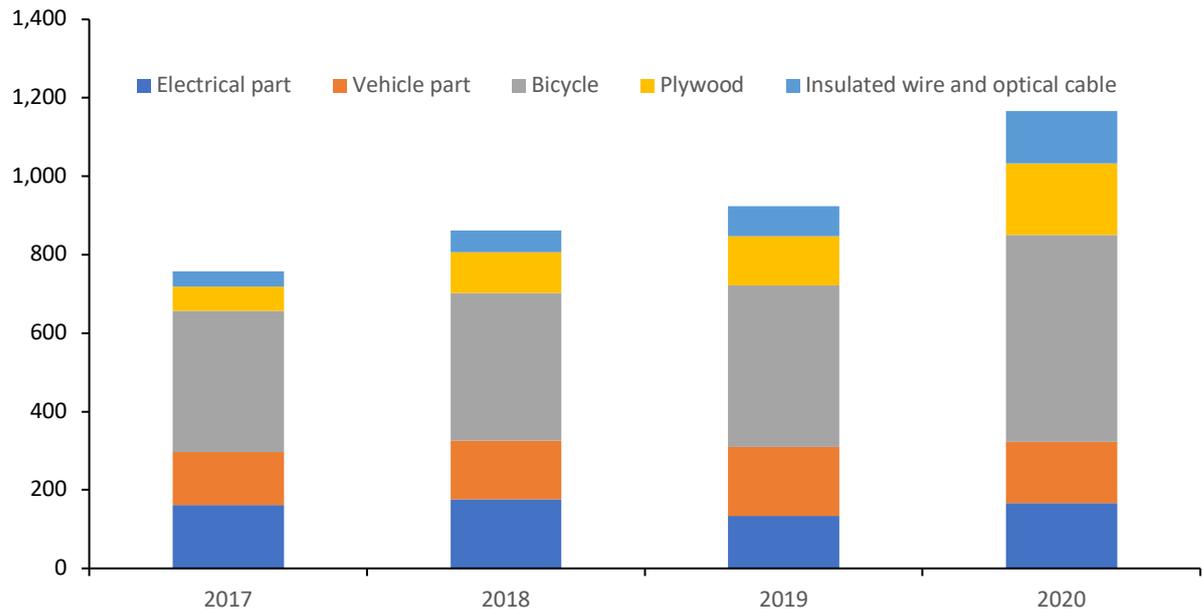
Source: Authors' estimates using data from Royal Government of Cambodia.

In addition to economy-wide interventions, the government should also consider sector-specific initiatives to boost growth. Cross-country comparisons suggest that much of the potential benefit of moving workers from agriculture into other sectors have already been realized. While the inter-sectoral transfer is usually associated with a one-off increase in the *level* of productivity, future growth will require adoption of improved technologies and an intra-sectoral reallocation of factors towards production of higher-value differentiated products or higher value-added activities.

Exports of agricultural products have been growing steadily and the Cambodia-China Free Trade Agreement (CCFTA) and a forthcoming agreement with South Korea offer additional opportunities to expand agricultural exports. To realize this potential, Cambodia will need to strengthen the infrastructure and institutions for trade in agricultural products. This includes development of laboratory and food safety capacity as well as specific sanitary and phyto-sanitary protocols for food exports (See Roeun and Hiev, 2022). There is also scope for well-targeted public policy to support innovation in agricultural production and food processing. This includes greater use of digital technologies, as well as introduction and dissemination of more advanced production technologies.

In the manufacturing sector, strong growth in exports of garments, travel goods and footwear (GTF) and approval of new GTF FDI projects in 2021 and Q1 2022 suggest that Cambodia retains a competitive advantage in this sector. However, this is likely to be gradually eroded by rising labour costs and the eventual loss of trade preferences following LDC graduation. While the GTF sector accounted for 57.6 per cent of merchandise exports during Q1-Q3 2021, non-GTF manufacturing exports have been growing rapidly (Figure 4).

Figure 4.
Non-garment manufacturing exports, \$ million

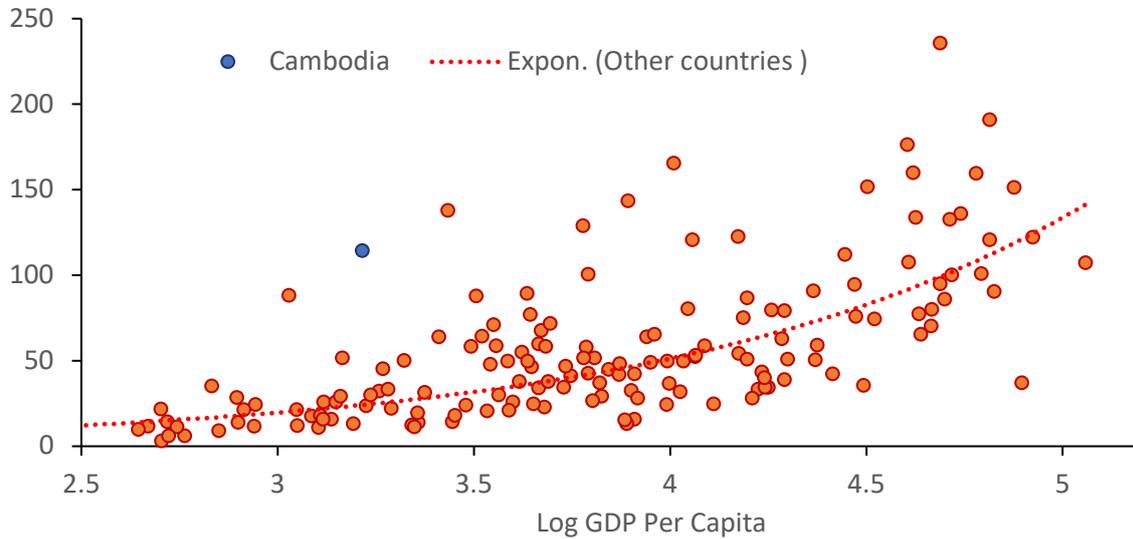


Source: Authors' estimates using data from Royal Government of Cambodia.

To sustain this growth, Cambodia should implement measures to strengthen the efficiency and competitiveness of its special economic zones (SEZs) and industrial parks (see Warr and Menon, 2016). Potential measures include adoption of voluntary frameworks to enhance SEZ's environmental sustainability, improved regulation and facilitation of firms operating in SEZs, and promotion of industry clusters to encourage agglomeration effects. Developing industry-relevant skills will also be crucial, and so the government should collaborate with business associations and manufacturers to develop industry skills transformation maps that can be implemented through public-private partnerships.

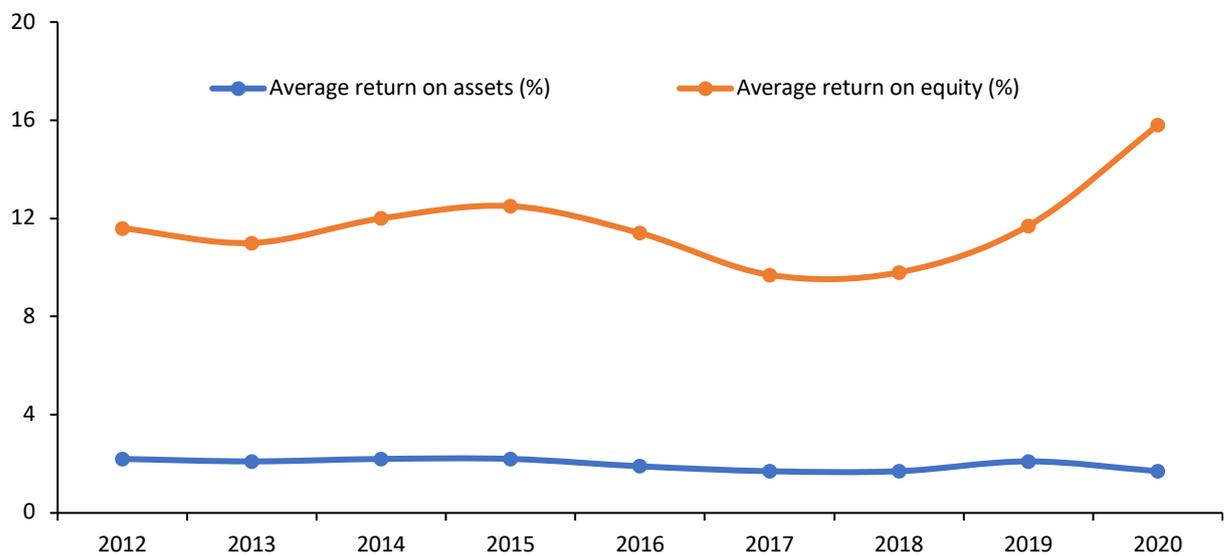
Tourism recovery and the shift to higher-value tourism can also contribute to growth but Cambodia will need to improve its competitiveness to achieve this. The government is currently implementing a phased tourism sector recovery plan spanning 2020-2025. Visitor arrivals have increased following the re-opening of borders but remain below 10% of pre-COVID levels.² The pandemic is expected to lead to long-lasting changes in tourism demand including increased emphasis on social and environmental sustainability (ADB, 2022). Cross-country comparisons suggest that Cambodia lags on key dimensions of tourism competitiveness needed to capitalize on the shifts in demand. For example, Cambodia ranked 98th in the world Economic Forum's 2019 Travel and Tourism Competitiveness Report and was the lowest ranked country in Southeast Asia, with notable gaps and weaknesses on environmental sustainability, human resources, and tourism service infrastructure.

Figure 6.
Ratio of private sector credit to GDP (%) 2019



Source: Authors estimates using data from the World Bank’s World Development Indicators

Figure 7.
Average return on assets and equity of licensed banks in Cambodia (%)



Source: National Bank of Cambodia. Banking Supervision Report, various years

Recognizing the scale of the economic impacts arising from COVID-19, the National Bank of Cambodia (NBC) moved quickly to introduce a package of regulatory forbearance measures. This included a deferral of the planned increase in the bank’s capital conservation buffer and a loan restructuring programme. The restructuring programme was initially

targeted at sectors directly impacted by COVID-19 but was quickly expanded to cover all private lending. Under the programme, banks and MFIs could suspend loan interest and principal repayments and adjust the schedule of repayments without reclassifying a loan as non-performing. This enabled banks and MFIs to accommodate borrowers' needs for flexibility without large-scale provisioning that would have constrained new lending.

Uptake of the loan restructuring programme has been significant. By end 2021, \$5.2 billion in loans had been restructured, equivalent to 12.9 per cent of total private sector lending, and 19.9 per cent of GDP. At the same time, new lending continued to grow. As a result, the total stock of private sector lending increased by 52.9 per cent during 2020-2022, with loans to businesses rising 47.6 per cent while personal loans rose by 73.6 per cent. The restructuring programme was extended several times and is now due to end in June 2022. While reported NPLs have remained low to date, the proportion of loans that are non-performing is likely to increase as the restructuring programme is phased out. No data on the distribution of restructured loans by bank or sector have been published but NBC carried out on-site supervision and stress tests in Q4 2021 to get a better understanding of possible risks. It has also instructed banks to postpone dividend payments in order to retain capital and has encouraged some banks to increase their capital base.

A related concern is that some banks, including large locally owned banks have quite high exposure to the construction and real estate sectors. The growth of the property sector has also been associated with increased shadow banking by real-estate developers. A new Non-Bank Financial Services Authority has been established to strengthen regulation and supervision but will need time to become fully operational. Cambodia's authorities have also been encouraged to accelerate work on the establishment of a deposit protection scheme, implement measures to prevent money laundering, and clarify the framework for bank resolution (IMF, 2021b).

The recent pace of credit growth cannot be sustained indefinitely, however, and has led to growing concerns about over-indebtedness. The rise in imported inflation through supply chain disruption and increase in energy prices raises concerns over domestic inflationary pressures. However, a sudden tightening in the availability of credit would have a significant impact on economic growth.

Cambodia's authorities will therefore need to carefully monitor the health of banks and MFIs as the forbearance measures are phased out and be ready to intervene as needed to maintain financial sector stability. Systemically important banks with concentrated exposure to construction and real-estate should be closely monitored. A staged increase in minimum capital requirements could also be used to promote consolidation in the banking and microfinance sectors but would need to be managed carefully.

SUMMARY AND CONCLUSIONS

Cambodia has been heavily impacted by both the direct effects on health from the COVID-19 virus and from measures designed to curtail its spread. Almost two years after the pandemic, Cambodia is moving ahead with re-opening. An impressive vaccination campaign and pragmatic economic policies have helped position the country for economic recovery. However, risks remain, and three key challenges must be addressed to support post-pandemic recovery and long-term growth.

The first relates to maintaining health security and the need to strengthen the healthcare system. The capacity of the healthcare system remains one of the lowest in Asia. Had there been more healthcare capacity to work with, the government could have employed a more targeted approach in managing the outbreak and reduced the toll on the economy and livelihoods.

The second challenge is to identify and support new sources of growth. While the construction and real estate sectors accounted for about a fifth of growth in the decade leading up to the pandemic, this is unsustainable and will not continue. Future growth will need to come from diversification within agriculture and manufacturing, with a move towards higher value-added activities supported by greater investment. Foreign investment is likely to play a key role in enabling this transformation and improving domestic infrastructure, and upgrading local skills will help ensure that Cambodia is well positioned to attract high quality investment. A revival in tourism will also aid recovery but will also need more investment for upgrading to cater to higher-spending tourists.

The third and last challenge relates to managing financial sector risks. The forbearance measures related to the pandemic, cooling of the property sector and slowdown in growth have increased the indebtedness of households and firms. The winding back of the support measures needs to be carefully managed to avoid a financial meltdown, while increased regulation and supervision is required for long-term financial sustainability.

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ENDNOTES

¹ The WHO has suggested that rates under 10 per cent indicate adequate testing (see Menon, 2021a)

² Authors' estimates using data from the Royal Government of Cambodia.

³ Foreign currency deposits accounted for over 80 per cent of broad money (M2) during 2014-2022 while in 2019, deposit taking corporations had \$6.5 billion in external liabilities (equivalent to 24.1 per cent of GDP).

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