



# CICP Commentaries

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### **The Cambodian Banking System: Adverse Selection and Moral Hazard**

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According to International Monetary Fund (IMF) Mission report released in March 2009, Cambodian economy would fall into a recession in 2009. The forecast real growth rate for 2009 was revised from 4.75 percent to -0.5 percent while the Ministry of Economy and Finance (MEF) still is optimistic the economy may grow at least 2 percent. They revised the forecast real growth rate for 2009 from and earlier 4.75 percent to the most recent -0.5 percent while the Ministry of Economy and Finance (MEF) is still optimistic that the economy may grow at least 2 percent.) This optimism must require significant interventions from both the government and the National Bank of Cambodia (NBC) because the main pillars of the economy namely garment industry and services including construction seem to be hardly hit by the global economic storm while agriculture, a vulnerable sector, still pins its fate on the weather.

In February 2009, the National Bank announced to cut the reserve requirement of foreign currency deposits from 16 percent to 12 percent. It is worth recalling that the requirement rate was just doubled in June 2008 to fight inflation which was deemed to be originated from the two-digit credit growth and a rise in food and oil prices in early 2008. As a result, money balances (in the whole economy or the banking system) significantly fell from roughly 60 percent in April 2008 to only 7 percent in November in the same year. Inflation was brought down from about 25 percent in May 2008 to around 13 percent by

the year end. At the same time, higher interest rate did hurt investors and in turn the economic growth. Therefore, the reverse monetary policy by releasing the reserve requirement may not turn back the economy at once, but it definitely lifted heavy pressure on commercial banks, especially those under liquidity constraint.

The policy target to ease the lending markets and get the credit to grow again may not (be) realize(d) and may require more than just pumping liquidity into the markets. The channel for credits to flow from banks to borrowers has become tighter and smaller. Banks are becoming more cautious in lending due to rising non-performing loans and even more frightened to lend against collateralized fixed assets when the real estate markets are currently sleeping like a baby. It is of no use for banks of to hold the collaterals which are originally worth double the loan while there is no demand for such collateralized assets. The rise in non-performing loans could be the problem of moral hazard in which commercial borrowers may have misused the loans to speculate the bubble housing markets before the crisis. Thus, it is very important to address the current stagnant real estate markets to increase the velocity of money in those markets. An effective measure may be to set up "programs" to help first home buyers. On one hand, these middle class working families are more likely to be willing-to-pay and able-to-pay borrowers. On the other hand, this could smooth the markets off speculative investors. Waiting for regional recovery and the return of foreign investments could be a far way to go.

At the same time, it is also important for the central bank to speed up the credit sharing system which needs to be made more transparent, more reliable and more accessible. In such an economic crisis, without accessibility to reliable credit reports banks are more likely to adversely select a borrower who is a "bad" customer. This adverse selection issue would play a role in restraining banks from lending even to a potential or "good" borrower.

To make the system work better, more beneficially and more reliably, it requires a significant involvement and participation from the commercial banks per se to reveal and provide accurate reports of their customers to the central bank. At the same time, the central bank as a regulator should also use their power to bring their participation.