LEOPARD CAMBODIA

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Sector Highlight

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W(h)ither Cambodia? Cambodia Economic Outlook

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As we go to press, financial and other markets globally continue to struggle as the world tries to find a solution to the banks' near death experience and the consequent drying up of credit. Cambodia, though insulated to a degree, is not immune. We at LCF are very much heartened however by the IMF's recently published country report on Cambodia which makes for very interesting reading: considerably more positive than negative it nevertheless pulls no punches:

'Growth is slowing, liquidity is tightening, and, as a result, banks' balance sheets are coming under strain. Competitiveness has eroded given the recent sharp real appreciation of the Cambodian riel and U.S. dollar'.

And few readers will be surprised to learn that the twin 'villains of the piece' are excessive property development and the financiers of that development:

'The immediate risks to Cambodia arise from liquidity shortages among banks owing to a sharp slowing in external inflows and deposit growth. Over the past few years, these inflows have fuelled rapid credit expansion, which has bolstered economic activity and contributed to a boom in the property sector (LCF note: almost entirely condominium development in Phnom Penh.) As conditions tighten, bank lending has moderated, construction activity has slowed, and property prices-after reaching historic peaks-appear to be declining. Some banks, including several large ones, could face a large deterioration in credit quality and a need for recapitalization, depending on the magnitude of the current slowdown and effectiveness of the policy response. Others have entered Cambodia recently with limited banking experience or large exposure to the property sector, making them especially vulnerable to external conditions and an economic slowdown'.

And the global slowdown, particularly the slowdown in the US (40% of garments exports), has hit export dependent Cambodia hard:

'The economy has been particularly vulnerable to recent shocks given its narrow production base, concentration of exports by product and destination, and dependence on external inflows. As a result, economic activity is slowing in most sectors and liquidity conditions are tightening as funding sources dry up'.

All of which means a slowdown:

'Growth is projected at 4.8 percent in 2009.While agricultural output is expected to pick up, garments and tourism would act as a significant drag given weak external conditions. Real estate and construction activity is expected to decelerate further, as investment becomes more constrained by inflows and credit'.

Or, to put it simply, the Americans cannot afford to buy so many new clothes, the Europeans cannot afford to put occupancy rates back up to the recently seen highs of 95% in Phnom Penh, the Koreans have learnt the hard way that there is no point in building condominiums unless there is sound fundamental demand for them and the (mainly foreign owned) banks in Cambodia are wishing that they had not lent quite so much money to developers, particular to those with such excessively prosaically named projects such as CamKo City (CAMbodiaKOrea-geddit?). With a name like that you just know that the development is another Muang Thon Thani, the Kanjanapas brothers' similarly out of town piece of pointless hubris which eventually became Bangkok Land's nemesis.

So is it all gloom and doom? Far from it:

'the overall budget deficit has remained low, with revenue rising rapidly and expenditure appropriately restrained. To the government's credit, national elections in mid-2008, which were largely peaceful, and ongoing border tensions with Thailand have not exerted extraordinary pressures on the budget so far'.

and:

'The fiscal stance continued to underpin the government's stabilization efforts in 2008.The overall deficit is expected at around 1¾ percent of GDP, against an official target of 4¼ percent and an outturn of around 3 percent in 2007. Revenue continues to rise (including as a share of GDP), owing to a buoyant domestic economy and improved tax and customs administration, with a pilot of the ASYCUDA system launched and ad hoc tariff exemptions reduced. Current expenditure has been in line with planned allocations, including a mid-year fiscal package'.

Or, in other words, the Government are not being profligate with peoples' taxes and with donors money and they are also becoming administratively more efficient.

And the IMF clearly takes the view that the Central Bank is doing a fair job:

'In response to excessively loose conditions in the first half of 2008, the National Bank of Cambodia (NBC) doubled the reserve requirement on foreign currency deposits (FCDs) to 16 percent in June. It also placed caps on banks' lending to the real estate sector.

Credit growth, which exceeded 100 percent (y/y) in mid-2008, is expected to fall to around 60 percent by year-end. Despite recent global developments, the riel has remained generally stable against the U.S. dollar since mid-year'.

Inflation is easing too (albeit with a caveat):

'Inflation should continue to fall, based on the IMF's latest commodity price outlook and moderating demand pressures.Headline inflation is projected to decline to around 7½ percent (y/y) by end-2009. However, the lagged effects of high inflation in 2008 could still yield upward wage pressures.'

So the economic picture, though less rosy than one year ago and perhaps a bit more 'frontier' in its risk profile, is, as the IMF makes clear, reasonably sound and manageable. The ever pragmatic Hun Sen Government listens-always a good sign. And with both external and internal demand tailing off as credit dries up, asset prices ease, highly geared speculators get burned, and Cambodia becomes, at least for now, a buyers market. The investment fundamentals of the country remain sound of course: minerals onshore and gas offshore, cheap and highly fertile agricultural land, tremendous tourism potential with Angkor Wat, Angkor Thom, 'hip' (as the 'Financial Times' described it) Phnom Penh and beaches as empty as pre cheap flight days. These natural resources, combined with a young, growing and increasingly English speaking population and with a highly pragmatic Government make for what we see as one of the few great untapped Asian investment stories remaining. For the moment, it's a buyers market. Fortunately we are buyers and equally fortunately we have a little cash.

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For those addicts of the 'dismal science', we have summarised the IMFs' medium term view of the economy:

The IMF medium term view of the economy is cautiously optimistic:

'Medium-term prospects depend on maintaining macroeconomic and financial stability, improving governance and infrastructure, and taking other actions to strengthen competitiveness. Under the current baseline, growth is projected to rise gradually to 7-7½ percent a year, driven by FDI-promoted export opportunities, broader tourism development, and higher agricultural yields-each critical to sustained growth and poverty reduction, including meeting the Millennium Development Goals. The current account deficit would narrow to 5-6 percent of GDP with further export diversification, even accounting for large investment-related imports. Under this scenario, the reserve cover would settle around 2½-3 months of imports. Underpinning stabilization efforts would be modest fiscal consolidation over the medium term, with the overall budget deficit narrowing to less than 2 percent of GDP by 2012.'

Moreover, the authorities, with IMF help, are beginning to get to grips with the banks:

'Excessive credit growth, regulatory forbearance, and now tighter funding conditions have heightened risks to the banking sector.Staff urged much closer monitoring by the NBC of banks' compliance with prudential regulations to prevent systemic problems. The NBC continues to improve supervisory capacity, with plans in 2009 for more intensive on- and off-site monitoring. However, enforcement remains weak, in particular dealing effectively with capital adequacy and loan provisioning. Staff also noted that bank licensing procedures need to be strengthened, with new entry reserved to those entities with a significant banking background. To this end, the NBC was urged to ensure close coordination between its recently established Financial Intelligence Unit and Banking Supervision Department to ensure new and existing banks complied fully with anti-money laundering guidelines. Finally, staff welcomed the updating of fit-and-proper rules.'

And the IMF's final appraisal? It reads quite well we think: in essence it says 'you are doing OK Cambodia and you'll be fine, provided you continue to take our advice':

- 'Cambodia is facing its most challenging macroeconomic and financial conditions this decade. *External shocks have been magnified by the concentration of economic activity, dependence on external inflows, and weaknesses in the banking system. The Cambodian authorities have swiftly recognized the serious challenges that lie ahead and agree on the necessity of a clear and timely policy response to manage the risks and avoid an even deeper downturn.'*

- 'Fiscal policy is expected to continue to underpin stabilization efforts, with a more expansionary stance in 2009 appropriate. *The government is to be commended for strong budget performance so far in 2008, especially given potential pressures arising from national elections, border security issues, and a weakening economy. Moderate fiscal easing in 2009 could help mitigate the impact of an expected growth slowdown. Concerted efforts are also needed to strengthen PFM, in particular on improving Treasury management and budget coordination and integration, including the recording of donor inflows. Finally, to maximize public gain, future oil and mineral production should be guided by a transparent fiscal regime.'*

- 'The current monetary stance is broadly appropriate, but conditions require close watch to avoid excessive tightening and aggravating risks to banking system. *As credit growth drops and inflation pressures subside, moderate easing could be justified. However, further steps are needed to improve policy effectiveness along the lines of longstanding IMF TA recommendations. A clear strategy must be put in place to manage liquidity risk.Upfront action should be taken to strengthen the liquidity management framework to deal with* *potential pressures. The NBC's recent moves toward putting in place an overdraft facility is a critical step in this direction, but caution will need to be exercised in assessing eligible collateral and distinguishing liquidity from solvency pressures facing banks.'*

- 'Beyond immediate actions to contain liquidity risk, swift and comprehensive measures are needed to improve banking soundness, including on solvency issues. *The NBC continues to strengthen the prudential framework, but more systematic efforts are needed in supervising banks and enforcing regulations, given the likelihood nonperforming loans will rise as the economy further slows.'*

- 'Risk of external debt distress is moderate, but could become more pronounced with a prolonged downturn. *In light of this possibility and given a large external borrowing requirement, prudent debt management remains essential, with Cambodia expected continue to borrow on largely concessional terms in the foreseeable future.'*

- 'If the need were to arise and understandings could be reached on outstanding debt arrears, staff would support a request for a new PRGF arrangement.'