Asianomics® Limited
www.asianom.com

InSight...

19 May2011

# Cambodia

**Phnom Penh, Cambodia**

Fresh air, blue skies, sun and landscaped promenades. We are in Cambodia for the third Leopard Cambodia AGM, of which we are a director of the general partner. Living in Hong Kong, or China, it is sometimes a surprise that there are places in Asia where the air is clean and the skies are blue. The pollution in Hong Kong doesn't bother us that much – we are too old to worry about it anyway – but it is depressing at times when you can't see Kowloon from Exchange Square. What a pleasant experience, therefore, to come to Phnom Penh.

Does the lack of pollution mean that Cambodia is off the investment radar? Not at all. It is just that the industrialisation process has a long way to run here and will be slower than in China because of the legacy problems of the Khmer Rouge genocide. Of course, to most readers Cambodia is not a particularly interesting investment opportunity. There is no stock market and the country is small.

However, the signs are that it will have a functioning stock market at some point this year. We visited with the Securities Exchange commission of Cambodia yesterday and they told us that 15 securities firms had been licensed (underwriters, dealers, brokers and advisers), that the Cambodia stock Exchange (CSX) had put in place its market operators, trading platform and securities depository and that all they were waiting for was the interface connection between the CSX and the relevant trading parties to come on line. Thereafter there are three state-owned enterprises – Telecom Cambodia, Phnom Penh Water and Sihanoukville Autonomous Ports – waiting to be listed, with around 10 private sector companies waiting in line thereafter. We will be participating at the outset.

That is not bravado (nor is it because we have an investment in the Leopard Cambodia Fund). It is just recognition that Cambodia is much more of a market economy than any other one-party state of which we know. In our 2009 report, *Asianomics* No 1, **Cambodia – The wild east**, 19 February, we pulled no punches as regards the corruption, concentration of political power and narrowness of the economic base of Cambodia. However, these drawbacks are overwhelmed by the fact that market signals work here. Two quotes from our meetings yesterday suffice to demonstrate:

"Cambodia has a strong Prime Minister but no government. It is the Belgium of Asia. You can do whatever you want."

"The private sector does not deal with the law but with the lords (officials)."

In our Cambodia reported we wanted to convey the message that Cambodia was today's Asian equivalent of the Wild West. Some people would see that as a disadvantage – lawlessness and anarchy – but we view it as a strength. We are dismayed by the unofficial taxation that pervades the system (official taxation is very low but the costs of corruption are high) but at the same time we are heartened by the government's willingness to step away from economic management.

Government official tax revenues are around 12% of GDP. Expenditures are around 16% of GDP and the gap is made up mostly by concessional aid flow. In other words, government is a small part of the economy. Furthermore, the market determines interest rates. The central bank has effectively adopted a dollarisation policy. It is claimed that 95% of economic transactions are made in dollars. Riel are much more widely used in the rural areas – which still accounts for a huge share of economic activity – but dollars dominate the cities. Banks are free to pay depositors market rates and charge lenders market rates. We asked the biggest foreign bank in Cambodia what that meant and were told that the blended cost of funds was around 85 basis points while lending rates were between 8-10% (the central bank numbers suggest deposit rates of 2.5% and lending rates of 16% but our contact said he had never seen such rates in the real world). However you look at it, this is a decent spread for banks – if only they could get their loan:deposit ratio above the 50-70% range.

The National Bank of Cambodia is described as the best regulator in the country and that is precisely what it is. It monitors financial ratios on a daily and monthly basis. It sets reserve requirements ratio and it allows capital flows to determine monetary conditions. It does not set interest rates. The market does that and the result is a much better capital pricing signal than is seen in most of the rest of Asia or, indeed, most of the rest of the world. Has it hurt the country? Figure 1 in the attached Insights charts file shows consumer price inflation in Cambodia versus its near neighbour, Vietnam.

Cambodian statistics are even less timely than Vietnamese but as the chart shows, there has been only limited consumer price increases in the country relative to Vietnam. Interest rates and monetary policy in the latter have been set by government dictat. This is further reflected in the way the countries' relative exchange rates have moved (Figure 2). The dong has depreciated over the last eighteen months as the State Bank of Vietnam has printed money hand over fist while in recent months the riel has appreciated (it has never strayed that much from CR4000/US$1) as money inflows have gathered pace. Letting the market work has its advantages.

But what about the economy? Our dire warnings of economic growth in the 2009 report were borne out. In that year Cambodia's real GDP grew by an estimated 0.1%, better than most of Asia where negative GDP was recorded but much worse than China (where the usual 9%+ was recorded, regardless of reality). But in 2010 the real GDP estimate was back up to 6.5% and nominal GDP was thought to be growing around 10%. Cambodia's narrow industrial base had bounced back as we thought – led by low-end manufacturing which is always relatively immune to downturns.

And now, as one contact told us, the manufacturing sector is really taken off. There is one new garment company per week opening in Phnom Penh. The strategy is straightforward: "get out of China". For low-end, unskilled manufacturing Cambodia is one of the top choices in Asia. The median age of the population is around 23 and the demographics dictate that wage rises are not yet on the agenda. China is just too expensive to manufacture garments in now. Cambodia's problem is lack of capacity, as well as expensive electricity. Nevertheless, the sector is booming.

As Figure 3 shows, there is probably too much liquidity coming into the system too quickly. Loan growth in early 2008 topped 100% YoY and it is back up to 30% YoY while nominal GDP growth is just 10%. But in fairness, the loan: GDP ratio is still in the 20-25% range. The National Bank would be well advised to raise reserve requirements ratio now – before a Vietnamese style problem appears – but even if it doesn't inflation accommodation is not that bad yet. As Figure 4 shows, broad money growth is actually decelerating, admittedly from a high base.

For anyone that is relatively new to investing in Asia Cambodia is worth a visit. It is today what much of the region was like 20 years ago. There are plenty of inefficiencies and there is a major problem of corruption but the potential is just plain to see. It is also an amazingly pleasant experience – and unbelievably cheap too. Moreover, it is a breath of fresh air seeing a country unfettered by authoritarian capitalism – see our latest china report, **The Fail of China**, for a definition of that particular route to hell – even in a one-party state. The 'Belgium of Asia' might sound like a slight but we view it as the reverse: no government is good government. Cambodia is still the Wild East but it is a foreign investor's dream as a result.

Come and visit soon.

Jim

Asianomics® Limited
www.asianom.com
Unit 1801-02, Wing On House
71 Des Voeux Road, Central, Hong Kong
Tel: (852) 3470 0011 Fax: (852) 3470 0022



**Figure 1: Consumer price inflation in Cambodia and Vietnam, % YoY - Divergence**

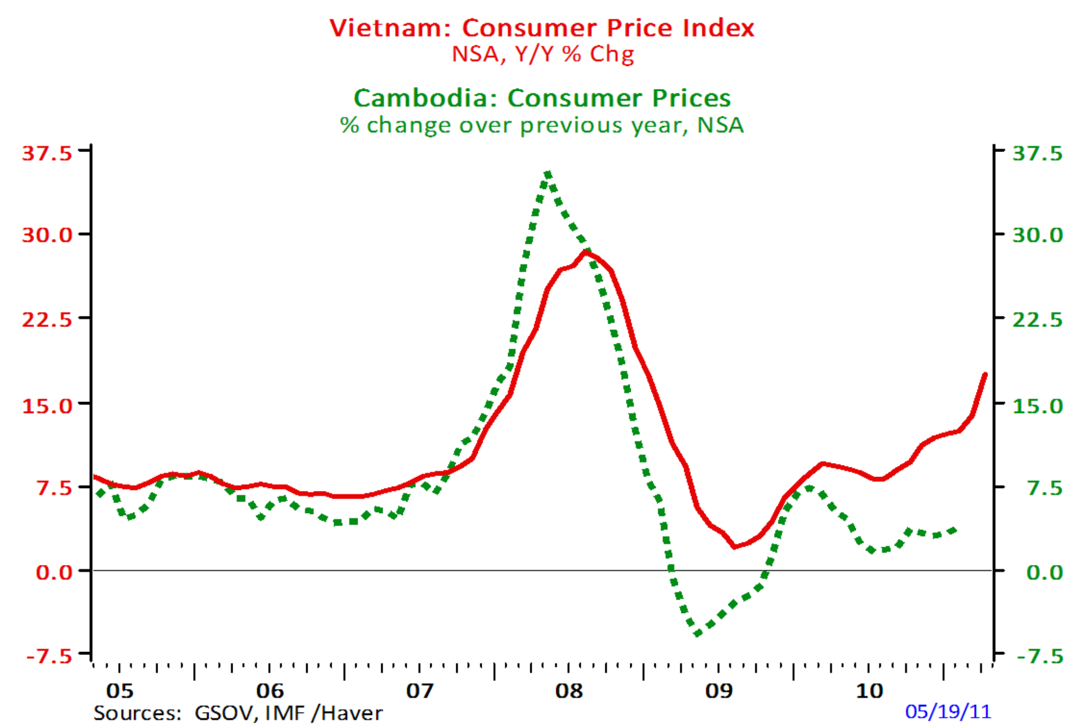

**Figure 2: USD exchange rate in Cambodia and Vietnam – More divergence**

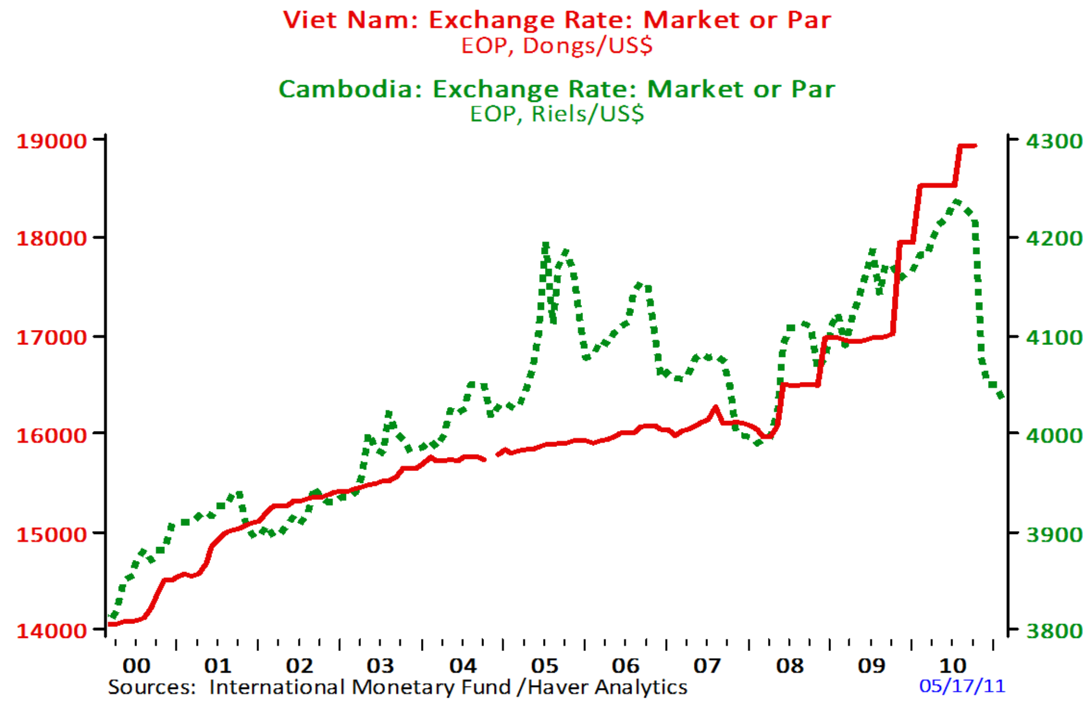


**Figure 3: Cambodia bank loan growth, % YoY – Too much liquidity but a low base**

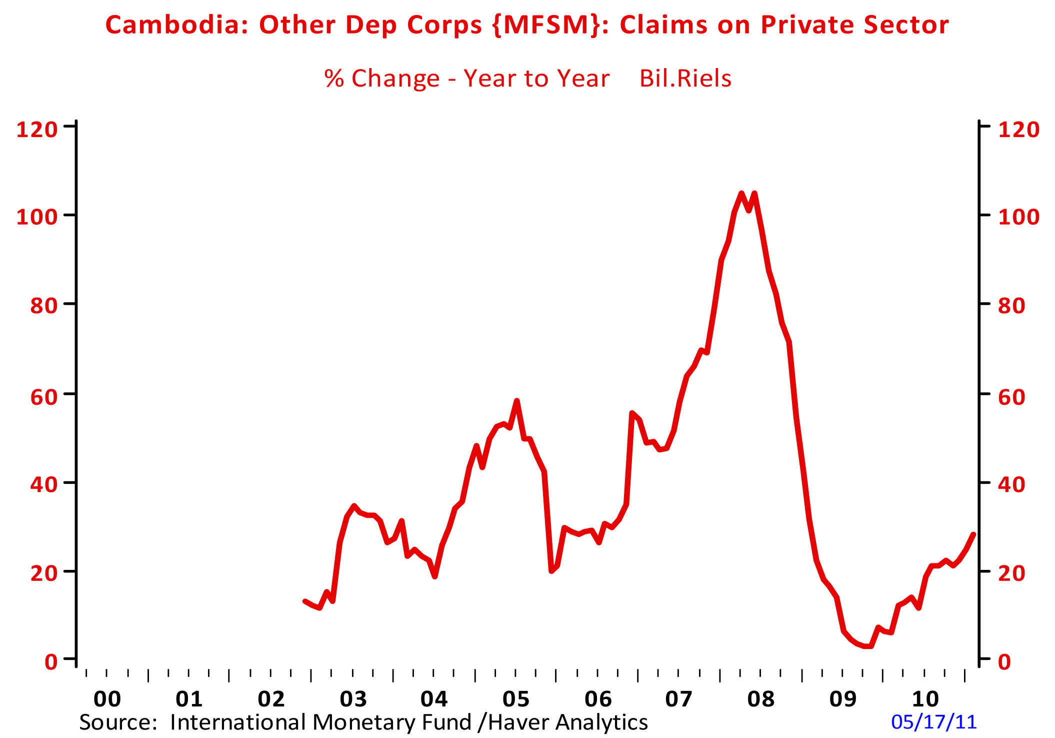

**Figure 4: Cambodia broad money growth, % YoY – Decelerating**