
Risk in Cambodia: a review of Country Risk Premium and its alternatives for investors and Cambodian financial markets

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Country Risk Premium applied

Just over a year ago, Javier Milei burst onto the political scene becoming President of Argentina. As a self-identified minarchist, he promised to take a chainsaw to government agencies and regulations to unleash Argentines from decades of state control over the economy ushering in liberty and restoring economic fundamentals to the beleaguered country. Thus far, his focus on economic principles has been showing signs of progress. Inflation is stabilizing, business confidence is growing, tariffs are falling, and the official foreign exchange rate is now much closer to the black market “blue dollar” rate in the country. One surprising effect is that economic ideas have become central to how Argentine’s view their country and its remaining problems. This is most easily seen in the Country Risk Premium (CRP), which measures the increase in yield needed by capital owners to consider investing in the country compared to a risk-free rate. The CRP is shown, alongside exchange rates, on a ticker on all TVs in Argentina. Great excitement and hope is palpable as the CRP continues to decline, from a recent high of 4362 bps in 2020, to now below 600 bps. It is an easy to understand number, both clear and measurable, that everyday citizens can use to track the progress of the country and which is bolstering the optimism of an economic comeback and attracting investment.

Cambodia’s Country Risk Premium - A comparative approach

How does Cambodia fare in this centrally important indicator for investors and capital flows? NYU’s Stern School of Business finance professor Aswath Damodaran regularly publishes this data and, at the time of writing, Cambodia’s CRP was calculated to be 734 bps. Essentially, this means that an investor with a 10% annual yield target would demand an investment yield of 17.34% in Cambodia for an asset with equivalent risk to a country, such as Singapore, that is considered “risk-free”. In the most recent data the CRP for Cambodia is 154% higher than the ASEAN average of 4.77% with only Laos and Myanmar having a less favorable CRP. Further still, Cambodia’s CRP of 734 bps is tied for 122nd globally with countries like Bangladesh and Rwanda. If alarm bells are going off in your head, you are not alone. I too thought it bizarre that the CRP for Cambodia is currently the same as Rwanda when the latter is in an active kinetic war with neighboring DR Congo. Historically, kinetic wars raise the likelihood of default and introduce great uncertainty into an investment climate. Further, Cambodia’s country-risk is tied with Bangladesh who recently experienced the Monsoon Uprising which saw Asia’s “Iron Lady” Sheikh Hasina toppled from power. Since Cambodia has enjoyed approximately 30 years of relative political stability when compared to both of the prior countries, perhaps we should look beyond mere political stability to make sense of the identical CRPs in the countries.

Choosing the geographically closer and developmentally similar country of Bangladesh is a logical starting point. Both Cambodia and Bangladesh have a GDP/capita of approximately \$2700 and are nearly identical in measures like GDP growth rate, Innovation Ranking, Corruption Index, Competitiveness Ranking, defense expenditure (as a % of GDP), and international credit rating agency’s

scores. All of these factors indicate that a similar CRP is warranted; however, many contrasting measures of a country's stability and, ultimately, ability or desire to repay an investor vary markedly. Measured as a % of GDP, Bangladesh's debt and deficit are, respectively, 150% and 165% higher than Cambodia's. All this has been achieved in Cambodia with, again as a % of GDP, expenditures on education and health at 137% and 227% the level of those in Bangladesh. In all these measures Cambodia is outperforming Bangladesh, yet the CRP is identical. Is an investor to believe that a country that is growing at a similar pace, investing more in the health and education of its workforce while running a lower deficit and holding less debt, is somehow of equal risk to the alternative of less spending on human capital coupled with higher deficits and debt in another country?

Perhaps the risk is arising from the monetary system and concerns over the potential for local currency devaluations to disrupt investment returns that require long-term planning. In local currency terms, the Bangladeshi Taka has contracted in relative value to the USD by approximately 48% in the last 20 years whereas the Khmer Riel has held steady with less than a 2% devaluation compared to the USD over the same time period. Here, yet again, Cambodia far outperforms Bangladesh and has demonstrated a remarkable level of consistency over the past few decades.

Yet country risk can also arise from the private sector, so examining the situation in the private sector might shed some light on the CRP. Cambodia has more stable, better regulated, and more adept oversight when compared directly. Over the last few years, Bangladesh has become known for massive, willful defaults and missing foreign currency in the banking sector. Most recently it was reported that, extremely high levels of non performing loans (NPL) are, "expected to reach 25-30% in the future" and that "these defaults have effectively already occurred and will only officially reflect in the coming months". These quotes come directly from a white paper released on December 1st by the Bangladesh Bank Governor Ashan H Mansur. In other words, the quotes are not from some alarmist making unfounded projections and the data is not inside information held by a private investment or short fund. This is in the public record and directly from a government official concerning the dire state of the banking sector in Bangladesh. The NPL rate is estimated at approximately 5-6% in Cambodia meaning

that default is happening at 5-6 times the frequency in Bangladesh. Since the financial and banking sector are so central to the viability of a national economy, a rational investor might expect this to weigh in the calculations of risk in a country. All of this comparative data vis-à-vis forms a fairly compelling argument that the risk of a country default in Bangladesh should not be judged to be equivalent to that potential in Cambodia.

Is the Country Risk Premium inaccurate?

It begs the question that perhaps the CRP is not as accurate as describing true risk as theorists believe. Mark Twain famously said that, "It ain't what you don't know that gets you into trouble. It's what you know that just ain't so." Investors that rely on the CRP might be in for a rude awakening by relying on the measurement. To test if investors are over relying on this critically important metric, one can look at financing rates in government bond markets. According to the logic underpinning the CRP, an investor would demand a 7.34% higher yield on a bond issued in Cambodia when compared to that of a risk-free US treasury. Data from government bond issuances in Cambodia shows that just ain't so. Granted, the Cambodian market is neither as liquid, deep, or reactive as the US treasury markets and might have potential future variance levels greater than what historical data suggests, but a report from Yuanta Securities estimates that the actual spread in bps between US Treasuries and Cambodian Government bonds range from 193 to 277 bps for 1 year to 10 yr durations. This indicates that the CRP overestimates the true market determination of Cambodian risk by a range of 265% to 380%. Those numbers suggest that the additional yield premium required by real world investors can be reduced by approximately 74% for short term durations and 62% for 10yr denominated instruments.

Takeaways for Cambodia

This is good news for Cambodia as some capital owners are not demanding returns as high as the CRP would suggest in order to invest in Cambodia. Perhaps this important metric is failing to capture investor sentiment in a meaningful way. In that case, Cambodia need not worry about the discrepancies between the CRP and the de facto risk-weighted requirements of investors.

However, the bad news for Cambodia is that many institutional investors- including sovereign wealth funds, pension plans, ETFs, and endowments - are bound by charters, legal restrictions and regulatory requirements to consider the CRP when making decisions about where to allocate capital. Large swathes of potential financing are therefore excluded from exploring Cambodian investment opportunities. So, as flawed as the measure may be, it has real world consequences for Cambodia and her ability to attract investment from the entire spectrum of capital owners in global financial markets. Cambodia might not be able to control the CRP but there are ways to provide assurance to investors that counter the impact of a high CRP.

This could prove to be a boon to Cambodian financial markets. Local banks, investment groups, and insurance companies can create Alternative Risk Premia (ARP) instruments to arbitrage differences between the CRP and capital market realities. Instead of merely utilizing “smart beta”, long only positions, ARP hedge by using both long and short approaches to trading risk. Many examples of these exist in other financial markets and utilize indicators derived from momentum, size, trend, value, carry and volatility - among others. These instruments can reduce the premium demanded by international investors by transferring the risk to local actors who feel the CRP is overvalued compared to ARP. The most vanilla of these instruments are bank swaps and credit default swaps. These ARP instruments could provide valuable in attracting, as an example, Scandinavian pension and sovereign wealth fund capital to help fuel Cambodia’s continued development. Until these instruments are available to trade locally, individual investors can participate directly via the ISDA in New York.

It was heartening to see Argentina taking steps to reduce their CRP and the public attention it is receiving. Yet as often said of inflation, if regular business owners are talking about it, your policies are already failing. It is not that Cambodia needs a large scale public education campaign on CRP and its impacts. Instead, Cambodia’s private financial sector should create financial instruments to ensure that actual financing costs are reduced for everyday Cambodians and SMEs. This is not only a public service to help keep Cambodia on target for the 2050 Vision, it also provides an additional source of revenue for the industry.