Economics Thailand

DBS Group Research . Equity . Thailand

20 March 2006

Another rough year

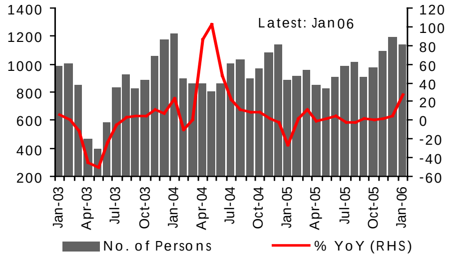
- We are maintaining our GDP growth forecast at 5.2% for 2006, with downside risk bias. Thailand's nascent recovery is being threatened by political uncertainties, with the opposition demanding Thaksin's resignation and boycotting the April 2 elections. Most end-game scenarios paint a bleak outcome, with a high risk of political paralysis regardless of the election result. Delays in infrastructure spending, privatization and liberalization, including the US FTA, will be inevitable.
- Domestic demand remains sluggish, hurt by both the fuel price and interest rate increases. The tourism and export recovery are the bright spots, supporting overall growth. Tourist arrivals rose some 34% in January this year, rebounding from the fallout following the tsunami early last year. Exports continue to grow in the mid-teens, driven by electronics and autos. The downside risk will depend on the resolution of the current political crisis, which if protracted, could hurt investments, confidence and tourism.
- We think the Bank of Thailand will conduct one more rate hike in the second quarter, bringing the 14-day repurchase rate to 4.75%. The next rate hike could fall on either the 10 April or 7 June meeting and will depend on political developments, which remains fluid. An interim pause at the 10 April meeting is increasingly possible, given sluggish domestic demand and a worsening investment outlook aggravated by the political crisis. The risk of a sharp slowdown has escalated relative to the danger from inflation, and the Bank of Thailand will likely take this into close consideration at the April meeting.

Exports & Tourism Recovering, Domestic Demand Sluggish

Forecast GDP growth at 5.2% (2006) and 5.5% (2007).

We are maintaining our GDP growth forecast at 5.2% for 2006 and 5.5% for 2007, with downside risk bias. Both the fuel price and interest rate increases are hurting domestic demand. The tourism and export recovery are however the bright spots, supporting overall growth. Tourist arrivals are up some 33.9% in January this year, rebounding from the fallout following the tsunami early last year *(Chart 1)*.

Chart 1: Tourist arrivals surging in early 2006



Source: CEIC, BOT

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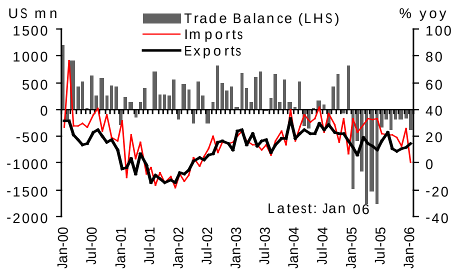
Exports, tourism and agriculture are the bright spots in 2006.

Exports continue to grow in the mid-teens, driven by autos and electronics *(Chart 2).* Agriculture should also do better, benefiting from the low base because of the severe drought last year.

Growth face downside risk bias due to political crisis.

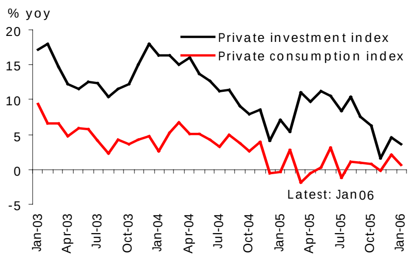
The downside risk will depend on the resolution of the current political crisis, which if protracted, could threaten investments, confidence and tourism.

Chart 2. Exports robust, trade deficit manageable



Source: CEIC, DBS

Chart 3. Domestic demand sluggish



Source: CEIC, DBS

Domestic demand remains sluggish in early 2006

January economic figures continue to show sluggish domestic demand in early 2006. Both private consumer and investment indicators weakened in January *(Chart 3),* growing 0.7% and 4.7% respectively (versus 1.0% and 5.0% average in 4Q05). Manufacturing expanded 5.8%, below the 4Q05 average of 7.6%. Farm output fared better, growing 3% in Jan 2006 versus -0.7% in 4Q05, benefiting from the low base because of the drought last year.

A Weaker Government Regardless of Election Outcome

Risk of policy paralysis with delays in infrastructure spending, privatization and liberalisation, including US FTA.

Political risks remain high, with uncertainty over whether Thaksin will survive the political standoff. Violence could erupt and the imposition of a state of emergency cannot be ruled out. An elections boycotted by the major opposition parties implies that the election result may not be credible. A weaker government appears the likely outcome in any case, regardless of the April election results.

Neither a weakened TRT party with a reduced majority nor a loose opposition coalition is likely to aggressively push for privatization, heavy infrastructure spending or liberalization for fear of antagonizing various special-interest groups. The risk of a by-elections later in the year is high given that under Thai law, a candidate who is unopposed still has to win 20 percent of the votes. Hence, there may not be any clear results in many of the seats.

Only small proportion of planned mega-projects will materialize in 2006.

The US FTA looks set for an indefinite delay, while most infrastructure projects will probably see the light of day only in 2007. Energy will likely be focused on maintaining political support and quelling internal party politics, with economic priorities sidelined. We are now only expecting about a fifth of the planned THB221bn (US$5.5bn) scheduled for 2006 to materialize, largely on low cost housing. Infrastructure-related spending, such as the mass transit project, may only occur in late 2007 and will depend on political developments.

Populist policies are already making a visible comeback ahead of the elections to mobilize rural support and appease state-owned enterprise workers. The government increased the salaries of state enterprise workers by 5%, backdated to Oct 2005, and also minimum daily wages. Salaries for head of villages and districts, and key local officials have been raised. Diesel prices for fishermen have been lowered by Bt2/litre or about 8% below the retail price of RM25/litre. Taxes on dividend received by non-listed corporates has been waived. The government is considering allowing higher deductible expenses to lower the income tax burden for salary workers. These populist policies could bring the fiscal balance back into deficit.

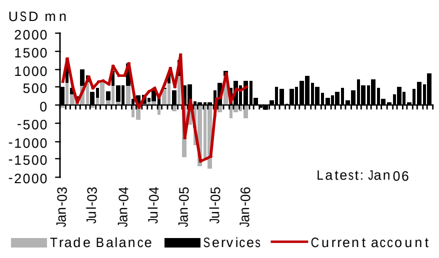
Populist policies making comeback ahead of elections, risk of straining fiscal position

Little Risk of Current Account Returning to Large Deficit Position

There is little risk of the current account balance returning to a large deficit position, given the delays in infrastructure spending and significant improvement in agriculture exports and tourism receipts. The current account has been registering a surplus over the last 7 months, since July 2005, following aggressive fuel subsidy cuts. The services balance has now normalised with tourist arrivals recovering strongly *(Chart 4).* Agriculture output and exports will likely improve to single-digit growth after contracting last year because of the drought.

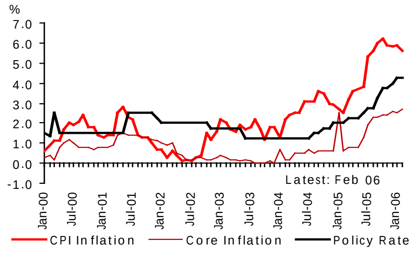
Current account to remain in surplus on infrastructure delays, tourism & agriculture recovery.

Chart 4. Services surplus supporting CA surplus



Source: CEIC, DBS

Chart 5. Headline inflation retreating



Source: CEIC, DBS

Bank of Thailand: One Last Rate Hike in 2Q06, Possible Pause at 2 April Meeting

We think the Bank of Thailand will conduct one more rate hike in the second quarter, bringing the 14-day repurchase rate to 4.75%. The next rate hike could fall at either the 10 April or 7 June meeting and will depend on political developments, which remains fluid. An interim pause at the 10 April meeting is increasingly possible given sluggish domestic demand and a worsening investment outlook aggravated by the political crisis.

Expect one more rate hike, either at 10 April or 7 June meeting.

The risk of a sharp slowdown has escalated relative to the danger from inflation, and the Bank of Thailand will likely take this into close consideration at the April meeting. CPI headline inflation retreated to 5.6% in Feb 2006 from the peak of 6.2% in Oct 2005, while core inflation remains well contained at 2.7% *(Chart 5).*

Risk of a sharp slowdown has escalated relative to danger from inflation.

Bank of Thailand's preoccupation with negative real rates & low savings may be overdone.

The Bank of Thailand's emphasis on negative real interest rates may be overstated by the use of headline inflation. Based on the core CPI inflation of 2.7%, real rates are significantly positive, at about 1.7%. Headline inflation is moreover expected to register a sharp drop in July to below 4%, given the surge last year following the fuel price hike. Real interest rates will definitely be positive by 2H06. We are forecasting average inflation of 4.3% in 2006 and 3.5% in 2007.

Headline CPI inflation to fall below 4% by July.

The savings-investment balance should be less of a concern given the return to small current account surpluses over the last 7 months, helped by improvement in the services balance, agriculture exports and delays in infrastructure spending. The current account surplus suggests that there are sufficient domestic savings to fund investment demand.

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