

ECONOMICS: ASIAN PERSPECTIVES—DECEMBER 16, 2011

Thailand's Recovery Will Fall Short of Official Forecasts and Prompt More Rate Cuts

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Despite the pickup in activity, we regard official projections of a 5% growth rebound in 2012 as too optimistic and expect 4.0%. Meanwhile, even with the increased funding requirement for post-flood reconstruction, we see limited risk of oversupply in government bonds in the current fiscal year.

After the Flood

Thailand's disastrous floods have highlighted the importance of the country's manufacturing sector to the regional supply chains of the automobile and electronics industries. As the water abates, attention is turning to how quickly the economy can recover. Assessments by politicians and bureaucrats are reasonably optimistic; in light of global uncertainties and various domestic considerations, however, we think the natural momentum of the recovery will be low, and that some policy stimulus will be required.

Prime Minister Yingluck Shinawatra expects all flooded areas in Bangkok and surrounding provinces to be dry by the end of the year. After the sharp 38.9% month-on-month plunge in manufacturing in October, some of the foreign manufacturers in the seven submerged industrial estates—for example, car manufacturers Toyota, Mazda and Mitsubishi, and hard drive manufacturer Western Digital—gradually resumed production in late Novem-

ber. The Industry Minister expects all flood-hit industrial estates in central Thailand to resume full operations by March–April 2012.

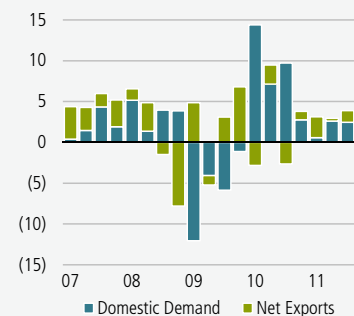
Recovery Will Disappoint the Market

Despite the steady resumption of activity on the ground, however, we regard official projections of a growth rebound in 2012—5.0% by the Finance Minister and 4.8% by the Bank of Thailand—as too optimistic, and we expect much more modest growth of 4.0%.

While replacement consumption and fiscal support will provide growth impetus in the coming quarters, we expect sluggish external demand, tighter credit conditions for small- and medium-sized enterprises and weak investment appetite in the private sector. These will constrain the momentum of recovery and, in our view, could prompt the Bank of Thailand—which initiated easing on November 30 with a 25 basis point cut in its policy rate, from 3.50% to 3.25%—to continue easing in

Display 1
External Demand Is a Growth Game Changer...

Net Exports and Domestic Demand Contribution to GDP Growth Percentage Points



As of December 14, 2011
Source: CEIC Data and AllianceBernstein forecasts

the first quarter 2012.

External Demand to Slow Recovery

Thailand's economy, in which manufacturing and hospitality constituted 40% of GDP in 2010, is vulnerable to external cycles. Indeed, net exports have played a key role in driving headline growth during recent years (**Display 1**), except in 2010 when the contribution of domestic demand was exaggerated by the base effect following the previous year's plunge led by inventory de-stocking.

The latest round of purchasing managers' index data in regional upstream hi-tech manufacturing countries such as Korea and Taiwan show no signs of recovery in export orders. While Thailand's hard disk manufacturers are likely to benefit from a one-off boost driven by accumulated demand following supply-chain disruptions, the boost is unlikely to offset the underperformance of the electronics sector that began late last year (**Display 2**).

Furthermore, the bleaker global outlook is likely to dampen discretionary spending in the advanced economies on passenger cars and pickup trucks. Consequently, even with a favorable base effect, following the disruptions caused this year by both Japan's earthquake and floods at home, the slowdown in the global industrial cycle will further constrain the pace of Thailand's recovery.

The Mirage of Booming Capex

In the near term, the replacement needs of impaired production facilities are likely to boost capital expenditure, fueled by incentives such as the temporary exemption of import tariffs for capital goods. Even so, in the face of rising uncertainty with regard to external developments, exporters may hesitate to restore full capacity outright. Indeed, the capacity utilization rate of all Thailand's manufacturers has stayed in the 60%–65% range for most months in the past two years (it plummeted to 46.4% in October). This suggests producers have leeway to delay part of their investment plans until they are more comfortable with the global demand outlook.

From a structural perspective, the vast scale of damage to capacity may be the last straw for those foreign manufacturers which, for other reasons, have already considered relocating their production bases away from the country. These reasons include the political unrest in recent years, the long-standing shortage of skilled labor and the drastic hike in minimum wages by an average 40%—

enough in itself to further erode the country's labor-cost competitiveness and dampen the appetite for expansion. Indeed, some spare-part manufacturers, including SANYO Semiconductor, have already announced decisions to relocate production away from Thailand.

SMEs Suffer from Tighter Credit

Small- and medium-sized enterprises—which account for more than a third of Thailand's GDP—are likely to lag the recovery because of constraints they face in accessing financial resources to repair their balance sheets.

Local media, for example, have reported that commercial banks will extend repayment periods for affected businesses but will not approve new loans as many of the affected businesses lack adequate collateral or guarantors. Although the government has offered low-interest-rate loans worth THB20 billion and loan guarantees of up to THB120 billion to help SMEs recover, such assistance may not be enough to cover the THB800 billion of damage to the SME sector estimated by the Federation of Thai Industries.

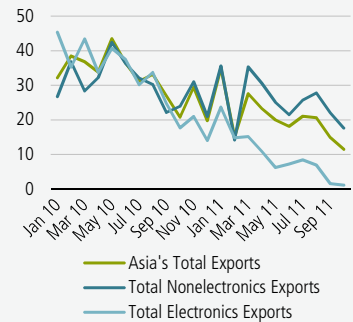
Another constraint is the low take-up of general insurance—as measured by premiums as a percentage of GDP—relative to developed markets in the region which have suffered severe natural disasters in the last two years (**Display 3**). The Office of Insurance Commission estimates that only 1% of small businesses in Thailand are covered for flood insurance. This all points to a gradual pace of recovery, in our view.

The Case for More Rate Cuts

We think that tighter credit conditions justify more proactive monetary easing by the Bank of Thailand (BoT), especially as they are compounded by the risk that commercial banks with already stretched loan-to-deposit ratios (**Display 4**) could cut business lending in response to growing macroeconomic uncertainty. While the central bank is likely to be

Display 2
...but Outlook for Hi-Tech Exports Is Muted

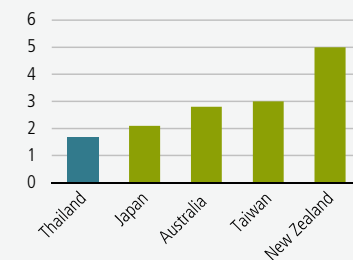
Asia (ex Japan) Growth in Electronics and Nonelectronics Exports
YoY % Change



As of October 31, 2011
Source: CEIC Data and AllianceBernstein forecasts

Display 3
Low Insurance Penetration Suggests Slow Recovery

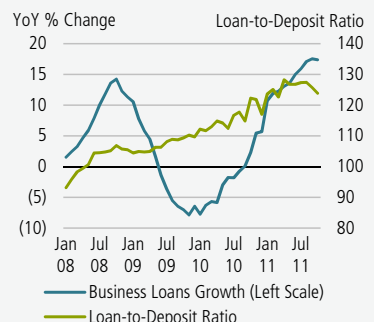
Nonlife Insurance Premiums as % of GDP in 2010
Premium % GDP



As of December 30, 2010
Source: CEIC Data, Swiss Re and AllianceBernstein forecasts

Display 4
Overstretched Lenders Pose Risk to Business

Thai Banks' Business Loan Growth and Loan-to-Asset Ratio



As of October 31, 2011
Source: CEIC Data and AllianceBernstein forecasts

conscious of the need for clear policy signaling next year, when it switches to targeting headline CPI instead of core inflation, we think it could make further emergency rate cuts without confusing the market or sacrificing the credibility it has earned for its inflation-targeting regime over the past decade.

There is scope for further rate cuts for two reasons, in our view. First, the central bank has said it will look beyond temporary price volatility caused by post-flood supply shocks (also, the release of rice stockpiles by the government in October could dissipate the increase in domestic rice prices). Second, the headline CPI target will be calculated on a 12-month moving average basis, implying that the policy target would not be breached even if CPI were to average 4.86% year on year (compared with 4.19% in November) in the next six months. On this basis, we expect the BoT to cut its policy rate by a further 50 basis points to 2.75% in the next six months.

Limited Risk of Bond Oversupply

Meanwhile, although the government has raised the budget deficit target in the current fiscal year by THB50 billion to THB400 billion (3.3% of GDP in fiscal 2012 compared with an estimated 3.8% in 2011) to fund post-flood reconstruction, we see limited risk of a resulting oversupply in loan bonds (LB).

First, according to the Budgetary Appropriation Act, total borrowing to fund the fiscal deficit cannot exceed 20% of budgeted expenditure plus 80% of budgeted principal repayment. This implies that, in order to avoid breaching the legislation, the budget deficit must be no more than around THB480 billion.

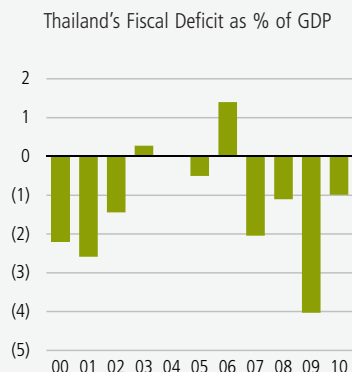
Second, even if the cabinet were to issue an executive decree authorizing the government to borrow beyond the legal restriction, the Public Debt Management Office (PDMO) could delay issuance of THB149 billion in securities to pay for Stimulus Package 2 (SP2) implemented in 2009 during the global crisis. On the face of things, the funding requirement for SP2 for the coming fiscal year is optional. Given that the additional issuance has been factored in by the market, such a delay could provide leeway to increase funding for flood-related reconstruction work, or to pump-prime the economy against the growing risk of global recession, without rattling the market's nerves.

Third, the government has an ample cash balance, equivalent to around 5% of GDP, which could also provide a buffer to finance additional post-flood expenditure without directly breaching the legislation.

While any distortion to the aggregate LB supply in the current fiscal year should be limited, the yield curve could steepen in the first half of next year. Because the 2012 budget was endorsed late (the fiscal year began in October 2011), the PDMO has announced issuance of only THB32 billion during fourth quarter 2011. This compares with an issuance target of THB540 billion for fiscal 2012 and implies that the PDMO will need to concentrate the planned LB supply in the first half of next year, causing the curve to steepen.

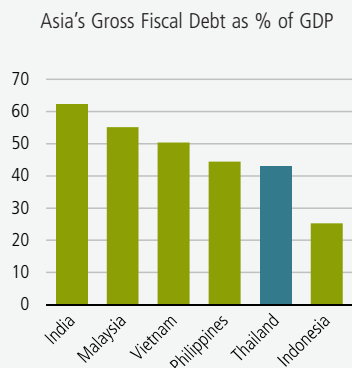
Despite a gradual increase in participation by offshore investors in THB government securities during recent years, however, the accumulated foreign position remains lighter than in Indonesia and Malaysia, suggesting that the local bond market

Display 5
Past Fiscal Prudence Should Comfort Market



As of December 31, 2010
Source: CEIC Data and AllianceBernstein forecasts

Display 6
Thailand's Debt Has Been More Modest than Its Peers'



As of October 31, 2011
Source: IMF and AllianceBernstein forecasts

should be relatively resilient in the event of a risk-off trade. This view is supported by the fact that the government has established credibility for fiscal prudence over the past decade (**Display 5**) and that the level of its fiscal debt to GDP has been modest compared with that of its regional peers (**Display 6**). ■

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