Thailand

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS April 30, 2013

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The economy has made a strong recovery from the double wham of natural disasters in 2011, and is set for a more moderate but balanced economic development in coming years, barring a resurgence of violent political turmoil or populist policies that can infringe on the country's competitiveness.

Country Risk Analysis

In 2012, the economy beat all expectations expanding at a rate of 6.4% on buoyant domestic demand propelled by reconstruction works following the natural disasters of 2011. Improving investor and consumer sentiment contributed following tax cuts for companies, government incentives for consumer spending and wage hikes for poor households. Only exports slowed in response to trailing global demand and the government's holding back of rise exports in an unsuccessful attempt at maintaining high global prices. Nevertheless, reserve build-up continued to almost 10 months of import cover, riding on a wave of short term capital inflows from yield-seeking investors. For 2013, by contrast, observers expect growth to slow down to 4-5% as in line with the longer-term growth potential and as the global environment will remain challenging for exporters.

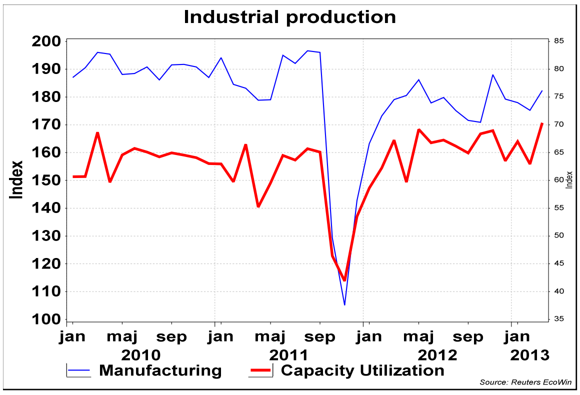
Recent performance is testament to the resilience of the economy to shocks. Combined with a diversified economic structure, attractive business climate and strong private banks this has prompted observers to up growth projections to 5%. We agree provided the government maintains prudent fiscal policies, reign in quasi fiscal activities of state owned banks and abandon wage hikes without relation to productivity or poorly designed redistributive policies. While the rise in the budget deficit to around 5%/GDP does not challenge fiscal solvency at this stage, over time it could have ramifications for Thailand's well-respected competitiveness. Present accommodative monetary stance combined with rising of domestic credit growth, increasingly funded from abroad, also deserves monitoring.

While the government is in a strong position to tackle economic problems before they become unmanageable, political worries are still looming. Political tensions have begun to cool but can still re-intensify with ramifications for business. That is despite the fact that the new government since 2011 commands strong parliamentary and popular support while the opposition is failing to rally the crowds Observers agree that events such as the return of the ousted but still popular previous PM, Dr. Thaksin, or the issue that is treated with discretion due to lèse majesté laws, have the potential to unsettle political calm.

That said, unexpectedly strong economic and financial resilience has begun to compensate for potential political turmoil. On that basis, the recent positive rating action of one of the agencies – one notch up to BBB+ -- did not seem to surprise markets.

Recent economic developments

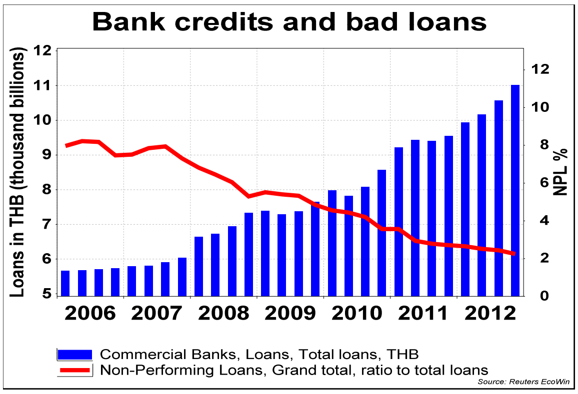
Fast recovery: In 2012, the economy beat all expectations expanding at a rate of 6.4%. The year started on a weak note following the natural disaster of late 2011 but soon gained traction as the flooding receded bringing factories and production plants back on stream while government lead reconstruction activities accelerated. In the last two quarters of the year annual year-over-year (yoy) growth reached 11% as a result of base year effects but also surging private consumption buoyed by hikes in minimum wages and the expiry at year end of government incentives including car purchases.. Also private investor sentiment improved propelled by tax cuts and a booming stock market. On the supply side, the recovery was broad based, headed by industrial production which quickly regained 95% of lost ground The only drag came from the trade balance due to slowing exports. Consumer price inflation remained well behaved, rising 3%, while unemployment stayed very low at less than 1%. The latter is according to official statistics which do not fully account for underemployment particularly in rural districts where agriculture engage 40% of the workforce but produce only 12% of GDP.



The current account surplus shrinks: Softening export markets coupled with a sharp drop of rice to reduce export growth to only 4%, down from 13% the year before. The drop in rice was entirely due to a delusion that the government could command international price formation by holding back rice shipments. In the event, competing countries like India and Vietnam took advantage of the situation to raise their own market shares. Imports, by contrast, continued at a normal pace of 10% expansion, thereby cutting the trade surplus by more than a half. The current account surplus also fell sharply from 1,7% of GDP to only 0,7%.

Surging capital inflows: Since 2012, inflows of capital to domestic equity and bond markets, including government bonds, surged as foreign investors sought higher yields than in home markets and as foreign central banks flooded markets with ultra-cheap liquidity. Net inflows into shares grew three times to almost $4bn, and private credit inflows rose to $21bn, of which banks received a third. Combined with the limited current account surplus of $3bn and inflows from bilateral creditors amounting to $5bn, this proved more than enough to finance a steep rise in outflows following earlier relaxation of Thailand's capital controls. As a result, reserve build-up continued to almost 10 months of import cover. Despite these inflows, foreign gross debt rose only 4 percentage points (pp) to $128 bn -- 35% of GDP, of which short term debt constituted less than a half. With reserves reaching $174bn at year end, Thailand remained in a strong net foreign asset position.

Banking system grows rapidly but remains sound: In 2012, credit to private borrowers continued at a rapid clip, accelerating to more than 15% through the year up from 12% one year earlier. Several factors played in including growing demand due to tax credits for first time home buyers but also supply factors such as lower interest rates and much improved funding situations for the banks including from foreign sources as noted above. Banks profitability and capital positions remained strong, however, while the share of non-performing loans (NPL) fell to less than 2,5%, much helped, of course, by the increase in the denominator, total loans. The rapid raise has nevertheless been noted by observers in particular against the high leverage of the private sector at 148% of GDP, the highest among peers and about at par with China (excluding shadow banking for that country). The relatively high share of it funded from abroad has also been compared with the run-up to the Asian crisis in 1997-98, even though observers are quick to add that the macro-economic situation is very different today. It has been noted, though, that the Bank of Thailand (BOT) recently pointed out that the situation warrants monitoring.

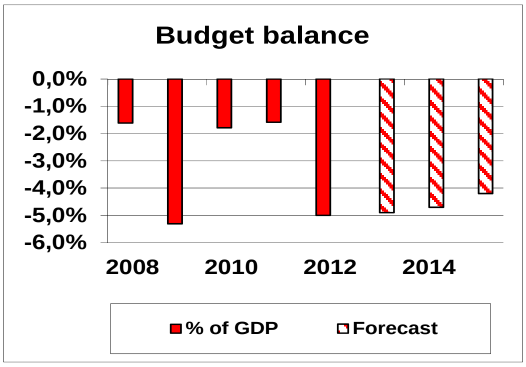


Growing dominance of specialized financial institutions (SFI): The SFIs are mainly state owned and often deposit taking institutions intended to implement the government's social and economic policies. They are overseen by the Ministry of Finance and suspicion is growing that they may not always be properly regulated. Last year two smaller such institutions went bankrupt after having amassed an amazingly high level of NPLs, in one case reportedly at 30% of total loans.

Policies:

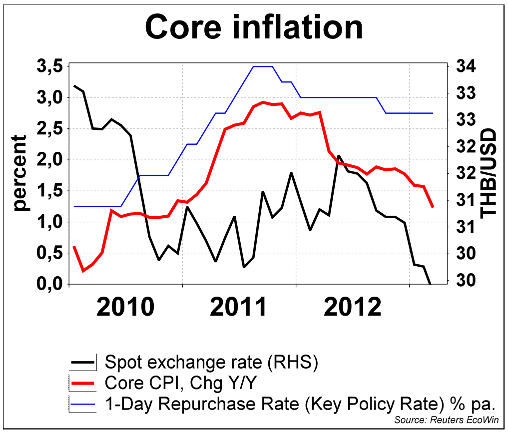
Since 2009, financial policies have generally loosened to offset negative external forces. So far the country has weathered these shocks beyond expectations, much helped by an adequate government response. The problem now is populist policies with potential longer term bearings on the budget while monetary policies are squeezed between a global liquidity and rapid domestic money growth.

The budget deficit rises: The record budget deficit in 2009 was soon reigned in as the global economy quickly recovered the year after, but the more recent spike of last year portends a structural issue. The budget deficit rose rapidly from the end of 2011 in line with emergency outlays to remedy the flooding catastrophe while drop in production and incomes hit the government's revenue basis. In the event, the budget deficit for 2012 soared to 5% of GDP, from less than 2% in 2011. The government is well aware of that in the longer term such a deficit is hardly compatible with the aim of maintaining market confidence and has detailed plans to reduce it to zero by 2017. That said, the fiscal balance is rapidly being undermined by populist policies to fulfil election promises, including tax breaks for business, cuts in fuel taxes and the price guarantee scheme for farmers, each of them estimated by the IMF to yield revenue losses for the budget at around 1,1%.



Rising off balance transactions and contingent liabilities. Another problem is that the government's consolidation plans must be seen in view of the growing tendency to keep new expenditures off balance. That includes for example the rice price guarantee scheme which is being financed by the state owned Bank for Agriculture, whose losses from this operation eventually must be covered by the government budget. In the future the government plans to spend an additional 2-3% of GDP on a large scale seven-years infrastructure project, most of it, reportedly, to be held outside the regular budget presentation.

Government debt still under control: Gross general government debt is still low at 40-45% of GDP. Including contingent liabilities related to state owned enterprises and financial institutions, the debt ratio increases to 50% of GDP according to official estimates. That is still not alarming because of long maturity with only 6% short term and less than 2% denominated in foreign currencies. As such confidence is still high that the budget situation is under control and that any short to medium term sovereign liabilities are well guaranteed by the government's large deposits with the domestic banking system at some 10% of GDP.



Monetary policy dilemma: The central bank has since many years pursued an inflation targeting regime with the target at presently set at 3%. In early 2012, due to the extraordinary situation, the central bank nevertheless lowered its policy rate to support the recovery. Again in last autumn it cut rates another 50bsp against a backdrop of abating price pressure and also excessive capital inflows. So far this has proved insufficient to discourage foreign investors and the baht has therefore continued to appreciate, rising 10% since last September. While the exchange rate was judged fairly valued by the IMF in last June, it is now about to present a problem for exporters.

Structural policies and government mega projects: Scoring in line with peers on corruption and rule of law but high on the World Bank's "easy of doing business"; Thailand has remained attractive to foreign investors despite periods of serious political turbulence over the last decade. Main complaints are often related to crumbling infrastructure which is squealing under the burden of rapidly rising passenger and freight traffic. The government has launched a large scale infrastructure project worth BHT2,2trillion ($70 bn.) or almost 25% of GDP to be implemented during the rest of the decade. However, some of this could now be under threat in particular the part designed around a transportation and utility corridor to the planned Dawei Economic Zone in Myanmar (Burma) west of Bangkok. This was agreed with the former military junta, but the new government in Myanmar has questioned its profitability and has got cold feet over its adverse social effects including the need to replace 30000 villagers. Also, in last March, rumours about legal proceedings against the PM caused turbulence in the stock market. Political disruptions are perceived as potential threats to such investment plans.

Political developments

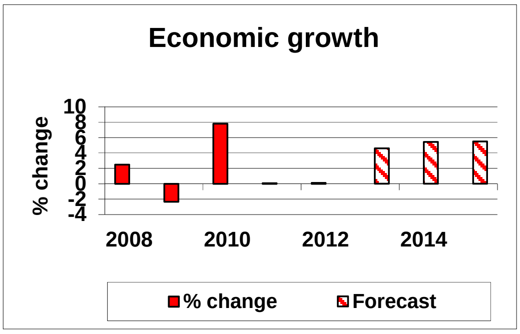
The Pheu Thai Party, of Thaksin supporters won a decisive victory in the June 2011 elections. The government formed under Ms. Yingluck, a sister of Mr. Thaksin , has used its time in office to consolidate its hold on power and fend off potential interventions from the military. At the same time it has been able to outflank its opponents in Parliament while the popular support for the latter has begun to erode. However, the political situation is still fragile and could be disturbed for various reasons -- both trifles and fundamental ones, of which the most contentious remain

- the possible return of Mr. Thaksin, who was ousted in a military coup in 2006 and later sentenced in absentia for graft and tax evasion. Such an event has still the potential to ignite massive street protests in Bangkok from the so-called Yellow shirts, vigilante groups connected to the largest opposition party, the Democrats.
- The situation of the monarchy and the event usually referred cryptically to *the one not to be mentioned by name* due to extreme lèse majesté laws. Nevertheless, with the present monarch ageing and uncertainties surrounding the Crown-prince, a fledgling debate about the country's highest constitutional institution appears to be simmering and last March almost went on air on one of the main broadcasting services before stopped in the last hour before transmission.

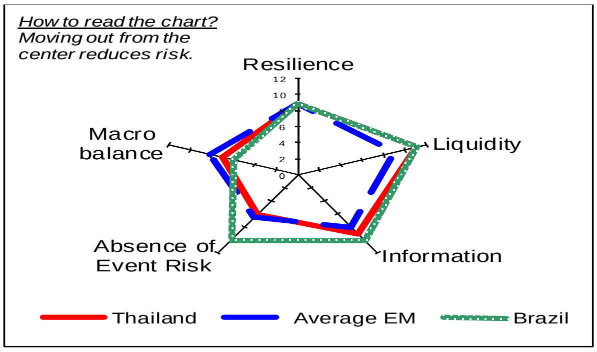
Underlying this is the deep cleavage between the middle classes of the main cities, in particular Bangkok, and the impoverished rural masses mainly in the North. The latter are mostly stalwart Thaksin supporters and often identified by other vigilantes groups, the Red shirts.

Outlook

We agree with the government projection of annual growth around 5% for the next few years, provided support from planned infrastructure projects. Downside risks to this scenario include an intensification of the euro crisis, although that is unlikely to trigger an economic collapse. (Conf. stress-test below.) The main challenge for the central bank in this period will be to manage expectations and steer monetary policies in order to avoid too rapid domestic credit growth with possible medium term knock on effects while keeping excessive capital inflows at bay. While having few pretension at predicting political developments, we take some solace from the fact that political calm has prevailed for almost two years now and appears to be gaining resilience.



Key ratios	2013
GDP/capita ($)	5816
GDP (change)	4,6%
Inflation	3,0%
Curr. Account balance/GDP	1,3%
Reserves/imports (months)	9
Budget balance/GDP	-4,9%
Central gov. debt/GDP	33%



External ratings:
Fitch: BBB
Moody's: Baa1
S&P: BBB+

Peers:
Brazil
Russia
India

Graph: The risk profile of Thailand is about at par with the average emerging market country on resilience and macro balance but better on liquidity. Event risk is higher than average and is now combined with also higher information risk.

Key data:	2008	2009	2010	2011	2012	2013	2014	2015
GDP (mill.US$)	276	264	319	346	367	403	419	443
GDP/capita (US$)	4096	3892	4682	5046	5316	5816	6021	6330
GDP (real change)	2,5%	-2,3%	7,8%	0,1%	6,4%	4,6%	5,4%	5,5%
Investments/GDP	22%	20%	21%	21%	23%	23%	23%	23%
Budget balance/GDP	-1,6%	-5,3%	-1,8%	-1,6%	-5,0%	-4,9%	-4,7%	-4,2%
Govt debt/GDP (*)	24%	28%	29%	29%	31%	33%	33%	33%
CPI inflation (%)	5,5%	-0,8%	3,3%	3,8%	3,0%	3,0%	2,3%	2,3%
Money demand (%)	2,8%	3,2%	3,4%	7,2%	19,9%	10,4%	5,0%	5,9%
Stock prices (yearly avg.)	676	588	857	1027	1227			
Interest rates	3,6%	1,6%	1,6%	3,1%	3,1%	3,1%	4,0%	5,0%
Exch. Rate ($)	32,97	34,31	31,70	30,47	31,05	30,61	31,75	32,42
Trade/GDP (%)	121%	102%	111%	122%	123%	121%	129%	137%
Oil price (Brent)	$97	$62	$79	$111	$112	$105	$109	$113
Millions US $								
Export of goods	175,2	150,8	191,6	219,1	228,8	247,9	276,2	307,8
Imports of goods	157,9	118,2	161,9	202,1	221,3	238,4	266,3	297,2
Other:	2,1	21,9	10,0	5,9	2,4	5,4	5,5	4,8
Current account	**2,2**	**21,9**	**10,0**	**5,9**	**2,4**	**5,4**	**5,5**	**4,8**
(% of GDP)	0,8%	8,3%	3,1%	1,7%	0,6%	1,3%	1,3%	1,1%
FDI	4,4	0,7	4,2	-4,1	-4,4	-4,8	-5,0	-5,3
Loan repayments	-15,2	-10,9	-9,7	-12,4	-14,5	-18,2	-21,0	-23,2
Net other capital flows	37,4	7,6	24,1	31,6	16,8	34,7	32,7	36,1
Balance of payments	**28,8**	**19,3**	**28,6**	**21,0**	**0,4**	**17,1**	**12,2**	**12,5**
Reserves (yearly avg.)	104,8	124,1	152,8	173,7	174,1	191,1	203,3	215,8
Total debt (yearly avg.)	48,1	54,9	66,2	75,8	78,4	94,6	106,1	118,4
o/w short term debt	18,9	24,1	34,2	39,1	40,5	42,1	43,9	45,8

(*) Central government only

Source: OEF (Oxford Economic Forecasting) and SEB estimates.

Rating history					
Fitch (eoy)	BBB	BBB	BBB	BBB	BBB
Moody's (eoy)	Baa1	Baa1	Baa1	Baa1	Baa1

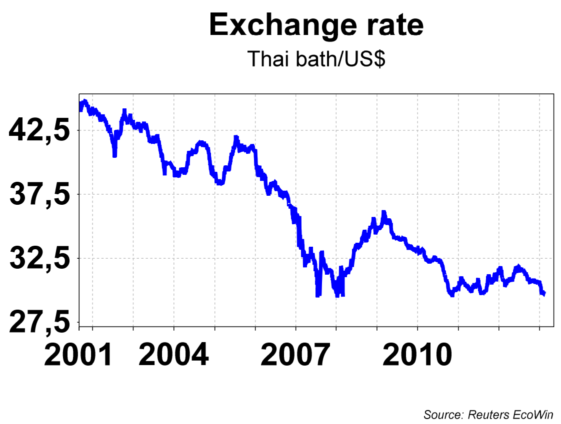
Type of government:

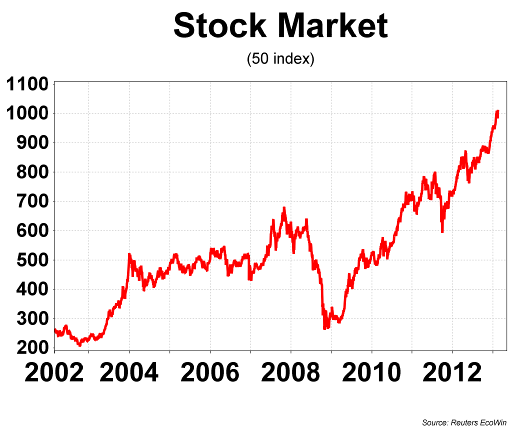
Next elections July 2015

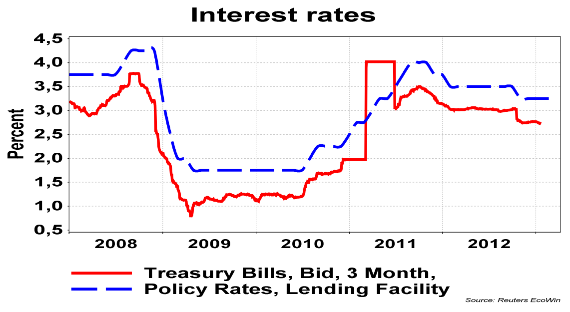
Other:

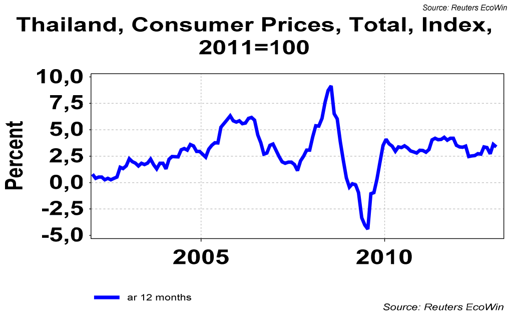
Latest PC deal None

Recent IMF programs Stand-by 1997









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