Thailand

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Political tensions have taken a turn for the worse and a pragmatic compromise seems remoter by the day. That would leave only two options: political stalemate that could weaken growth further or an undemocratic take-over to restore order but which might carry risks of a societal backlash.

Country Risk Analysis[1]

GDP decelerates sharply. Through 2013, the economy weakened at an accelerating pace. Consumption trailed in the wake of the end to the governments subsidized car purchase program and investors shied away from new projects in the shadow of rising political turbulence. The central bank was busy fighting capital flight with rate hikes. The slowing also reflected the high base year effect from 2012 when the country made a remarkable come-back following massive flooding. In the event, hoped for rescue by planned large-scale government spending on infrastructure has all but gone for now due to the political impasse and the transition of the Yingluck government into a care taker administration after courts nullified snap elections of last February.

Any hope in sight? The political stalemate has all the hallmarks of a conflict that may not end anytime soon but could turn worse before getting better. Even barring worst case scenarios that would include escalating violence, the short to medium term outlook for the economy does not look bright and 2014 could turn out even weaker still than the 2,9% growth achieved last year. Hopes are now for only a partial recovery in 2015 and that hinges on a breakthrough of the present political debacle to the benefit of investor confidence and economic predictability. That would demand a less confrontational attitude by the opposition and more willingness from the government to bite the bullet in terms of populism and the return from exile of its popular but divisive political leader and icon, Dr. Thaksin.

Underlying strengths still intact: Despite the present political problems which block new government projects some of which could be of dubious profitability, though, Thailand remains a well-functioning and diversified economy that should remain attractive to investors in view of often less spectacular alternatives. Foreign reserves are healthy, the twin balance is in relatively good shape, while external and internal debt levels are under control. Banks are strong enough to weather a temporary downturn although it is noted that household debt has grown rapidly to 80%/GDP – representing a potential bad loans problem. This risk combines with an expanding non-bank financial sector under lax regulations.

The rating agencies have so far remained on the sidelines. We share this view as regards the government, but think the country looks less healthy than a year ago.

[1] This report is based on publicly available information and information gathered during a recent trip to Bangkok that included meetings with representatives of banks and the local business community.

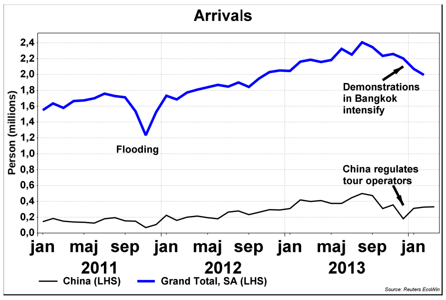
Recent economic developments

In 2013, hopes that the economy had regained its former strengths were dashed when fiscal stimuli were removed and new political turmoil eroded confidence.

The economy cools. Last year, the economy cooled unusually fast from a brisk opening of more than 5% yoy (year-on-year) in the first quarter ending at an almost flat 0,6% in the fourth yielding an average of 2,9% for the whole year. That was the weakest annual growth ratio since the Asian crisis at the end of the 1990s except for the global financial crisis (GFC) in 2009. The deceleration in 2013 happened for several reasons, including a high base year effect from 2012, when the country had recovered quickly from the flooding in 2011, an end to the tax-rebate for first purchases of passenger vehicles and homes, problems with shrimp production due to fish diseases and eventually the rising political uncertainty that intensified toward the end of the year. This hit manufacturing production, construction and agriculture on the supply side reflecting softening domestic demand including private consumption despite the hike in statutory minimum wages. Investment demand also suffered weighed down by overcapacity and high inventory levels in several industries.

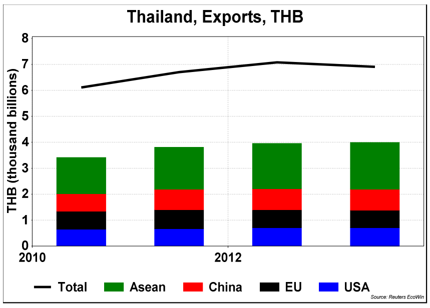
2014 does not look inspiring either: So far in 2014, key indicators have remained weak including a further 6% drop (yoy) of industrial production despite assurances from the manufacturing sector that political turmoil has yet to affect their business. Hopes are for activity to pick up in the second half of the year to yield a growth rate between 2,5 and 2,8%pa. – the higher estimate provided a near term political solution.

Tourism takes a beating: Last but not least, in the fourth quarter tourism was hit badly following an otherwise strong season for the industry. In October, Chinese travel agencies came under increased scrutiny from home regulators resulting in cancellations of trips to Thailand and, second, new political turmoil with mass demonstrations in Bangkok downtown began to defer security sensitive Asian tourists. Tourism is not a vital industry for Thailand, accounting for only 7% of GDP, but is an important employer in certain parts of the country.



Price pressure subsides: Softer domestic demand offset price pressure from exchange rate movements and cost push factors including wage hikes and persistent low unemployment around 0,7%. In the event the consumer price index, CPI, decelerated by one percentage point to less than 2% growth in late 2013, a situation that seems to have prevailed through the first quarter of the current year. Real estate prices, by contrast, continued their upward trajectory, particularly residential house prices in the greater Bangkok area. Indication are, however, that this is about to end now that the previous government's large scale infrastructure program, including for the capital, has been stopped by the courts.

External balances weaken but remain in overall good shape: Despite the slump in shrimp exports and softer global prices of rubber and sugar the trade balance improved by a sliver as exports still outpaced imports. Nevertheless the current account balance weakened somewhat to a shortfall of 0,7% of GDP on account of weaker services, net transfers and interest payments. The capital account, in contrast, met stronger headwinds despite a jump in net FDI (Foreign Direct Investments) mainly due to reduced activity by domestic investors abroad. Mid-year rumors about "Fed-tapering" triggered massive capital flight as in most other emerging markets. To avoid unjustified volatility in the foreign exchange market, the BOT -- Bank of Thailand (central bank) -- intervened by selling forex against THB. Although tapering fears ebbed after a few months, investors were once again stirred when turmoil of domestic origin began in the fall. At year-end central bank reserves were down by about $12bn to a still solid level of $160bn, however – enough to cover 8 months of projected import value for 2014, or the total of Thailand's foreign debt at $140bn. of which short term liabilities made up less than a half.



Economic policies

Removal of fiscal stimuli and ending of the emergency program after flooding late 2011 have strengthened the fiscal balance notwithstanding the general economic down-turn. This has supported an overall accommodative monetary policy stance.

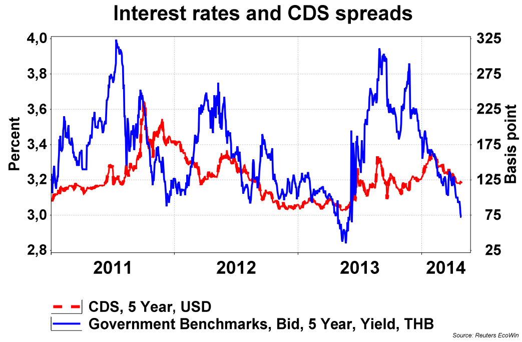
Fiscal deficits shrinks*:* The fiscal budget deficit for FY2013 -- the fiscal year ended September 2013 -- shrank by one percentage point to 2,3% of GDP.[2] That was mainly the result of reduced emergency outlays for repairs after the flooding in late 2011, cuts in one-off subsidies and tax relief for auto purchases, household appliances and housing introduced in 2012. These expenditure cuts more than offset the weaker performance of revenues as the economy lost speed through the year. So far in FY 2014, the picture is mixed. In the first quarter (the October to December period), the government over-performed on the investment budget apparently in a bid to kick start activity and bolster investor confidence while revenues in the second quarter were still down by 4% yoy. The likelihood is now for a new increase in the budget deficit as indicated by our whole year estimate of 3,3%/GDP shortfall. These estimates include off-budget transactions, without which the annual budget deficit comes out much lower, at 0,2% and 0,7%/GDP for FY2013 and FY2014 respectively.

Rice Pledging Program: In recent years, off-budget transactions have been increasingly dominated by the government's Rice Pledging Program (RPP). This has incurred potential losses as prices pledged to farmers have vastly overshot global market prices. So far this has left the government with mounting stocks of unsold rice, which will soon have to be sold at deep discounts relative to the purchase price

[2] Like many of its peers, Thailand's fiscal accounts can be presented in various ways whether one chooses to include off-budget transactions, government guarantees, debt of government controlled enterprises and financial institutions or different levels of the government structure. For example venerable institutions such as the World Bank and the Institute of International Finance (IIF) give widely different numbers for the fiscal position of FY2012 – which by now should be history -- respectively -2,2%/GDP ("cash deficit" – Economic Monitor Febr. 2014) and -4,9/GDP ("Public sector"; January 2014), while IMF takes the middle-ground with an estimate of -2,6%/GDP (Sept. 2013). While the World Bank and the IMF numbers may support a more complacent view of Thailand's public sector, the IIF estimate gives a more alarming signal. The latter includes, however, the now aborted RPP which, if materialized, will involve losses amounting to more than 2%/GDP in each year 2012-13 and about 1% in 2014, but thereafter none. Also, another aspect is that these numbers do not necessarily tell the same story in terms of annual fiscal developments. The numbers we present are based on the Oxford Economic model and include most off-budget expenditures except the RPP. These numbers are updated monthly.

before quality deterioration sets in. At that time losses may have to be realized as the alternative, to leave them with the government owned Bank for Agriculture and Agricultural cooperation (BAAC) does not seem to be an option. This bank has so far financed the program under government guarantees but as the new care-taker government since last February was no longer in a legal position to guarantee for BAAC borrowing, RPP had to be terminated. That left it with a debt of $4bn. to farmers for rice procured since last November but not yet compensated.

Government debt on solid terms: At end of FY2013, government debt stood at 31% of GDP, slightly down from FY2012. Including guarantees, however, the debt was considerably higher at 46%/GDP, but still clearly below the government's own self-imposed upper limit at 60%/GDP. Moreover, this debt is on favorable terms with long maturity reflecting investors' confidence with the sovereign in the past. Recent political turbulence has however, so far not manifested itself in notable worse borrowing terms for the sovereign as seen in falling interest rates on government bonds and more recently also declining CDS spreads.

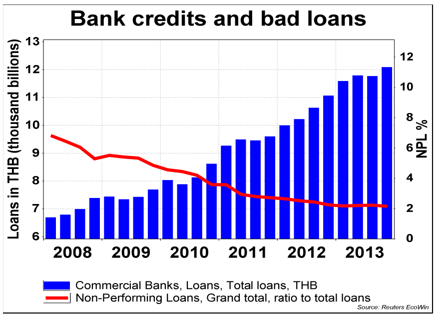


"Thailand 2020": In 2012, the new Yingluck-government launched a large scale infrastructure investment program to develop the central regions of the country with an industrial corridor stretching from Bangkok to Myanmar also including high speed trains between the country's main cities. The investment program – Thailand 2020 – was estimated to cost THB 7 trillion ($20bn.) over seven years or 1% of GDP per year during the construction period. It would eventually yield savings of about twice that for many years to come. However, it was not yet approved by Parliament when the government of PM Yingluck stepped down in December 2013. The political opposition then asked the Constitutional Court to rule on its legality claiming lack of specification would leave it open to misappropriations and corruption. Eventually, late March 2014, the Court ruled that the government's bill authorizing the Finance Ministry to seek 2 trillion baht in loans to finance the infrastructure developments was unconstitutional. That stalled the project which had inspired international investors. Hopes had been for Thailand to take advantage of its strategic position in the midst of South Asia not only for its own but also for regional benefits. Observers judge it may take years before anything like it can be relaunched.

Monetary policy accommodation: Under its charter of inflation targeting, the BOT (central bank) chose to act cautiously in 2013 as the currency had come under attack in the wake of general capital flight from emerging markets since mid-year. However as price pressure subsided further and the exchange rate demonstrated some resilience, the bank eventually lowered its policy rate two times, first in November 2013 and, second, in last March, each time by 25 bsp (basis points) to end at the current rate of 2% pa. That means a slightly negative real rate, but the bank argues that at the present juncture the threat of slower activity outweighs the risk to accelerated inflation. In addition, the bank indicates in its latest report that concerns about high debt levels among households may also play in on its assessment should higher rates inflict with their debt service ability.[3]

The baht may have shrugged off the worst of speculative attacks for now. The latest IMF assessment found the baht overall aligned with fundamentals including a reasonable current account balance. Moreover, BoT reserves are sufficient to withstand any temporary pressure should it reoccur in the near future.

Financial sector show some signs of concern. Having fought off the remnants of the Asian crisis in the mid-2000s, Thai banks may seem like fortresses of solidity. Even though capital adequacy fell slightly in 2013, it was still strong at an average of more than 16% of (risk weighted). Profitability is healthy and liquidity ratios have not given reason for concern as also dollarization is quite low. Banks should be well prepared for Basel III capital and liquidity requirements. Last, the share of non-performing loans of the total loan book has gradually reduced. That decline may, however, in part reflect the rapid expansion of bank assets to 129% of GDP, at par with many more advanced countries. It is noted that last year NPLs for consumer loans rose to 5,7% within its segment. That has apparently made banks raise lending standards with the effect to reduce credit growth to less than 10% yoy last December.



Could recent borrowing binge end in tears? The central bank and the larger commercial banks themselves are well aware of that recent years' rapid expansion of household credits could spell trouble should the economy not recover former strengths soon. This has raised leverage of the sector relative to GDP by a third to 80% over just a few years. The worry is in particular related to the poorer households that also took part in the borrowing binge including for car financing under the government's tax rebate scheme in 2012. Credit card companies and other non-bank financial institutions which tower almost as large as the banks have expanded even faster. They stood behind much of this lending often based on funding from banks. Such interconnectedness increases potential contagion to inflict damage on the financial system should something go wrong in any part of it. The IMF notes that non-banks are under laxer regulations by the Ministry of Finance than licensed banks which are supervised by the central bank. This carries the threat of regulatory arbitrage which has caused financial trouble in other parts of the world.

State owned financial institutions have joined the party: Ministry of Finance also supervises State-owned Financial Institutions which originally were designed to carry out policy initiatives. They have also joined recent years' lending binge. Last February, one of them, the government savings bank (GSB), experienced a run after depositors became worried that it was about to assists the BAAC financing the RPP. In the event, the government stopped the transaction. It is hard to say if this run was orchestrated by anti-government forces or if it signaled eroding confidence in the financial system.

Political developments

[3] Bank of Thailand, Monetary Policy Report, March 2014.

If it is not the economy, stupid, at the end of the day it is all down to politics-- and Thailand has had its decent share of in recent years. In fact, should the present situation of political debacle prevail beyond the next several months some investors may begin to wonder if the country has turned into a banana republic.

Calm overtaken by new turmoil: After bouts of turmoil following the military coup in 2006 and the subsequent ouster of the elected PM, Dr. Thaksin, hopes were high that political calm had descended on Bangkok when Thaksin's party – Pheu Thai -- again won land-slide elections in 2011 and his younger sister, Ms. Yingluck, was installed as PM. Calm lasted until the government in last October proposed to change certain undemocratic features of the Constitution implemented by the military rulers in 2007. These required half of the upper house to be anointed by the judiciary and independent agencies. When it shortly after also proposed an amnesty for political misconduct/offences between 2006-2011, the bill was perceived as a direct attempt at facilitating Thaksin's return from self-imposed exile. That triggered an aggressive political response including mass demonstrations in down-town Bangkok by anti-government forces which sometimes turned into violent clashes with the police and pro-government elements. In the event the government abandoned both bills, dissolved Parliament in December and called new elections.

New elections turn into a farce: Elections on February 2 were not only boycotted by the opposition – polls indicated that it would once again be defeated – but polling stations were also blocked by anti-government vigilantes. Attempts were made to arrange for supplementary elections in April, but that was stopped by the Constitutional Court referring to the legal requirement that elections take place nationwide on the same day. As such, the partial elections of early February were nullified and the government could continue as a care-taker administration only, limiting its actions to take initiatives that would bind future governments, including contracting new loans.

Courts pick on the government: In recent months, the opposition has asked courts to raise lawsuits against the government, the majority of Parliament and the PM herself for various offences such as the RPP scheme, the action to propose changes to the senate and most recently the PM's removal in 2011 of an opposition member from a political sensitive position in the public administration. That charge is now under court proceedings and is deemed the most significant by legal experts even though the related person was transferred to another position without penalty. (Conf. "Latest" below.)

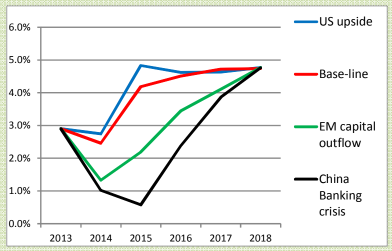
Military or judicial coup? Since the beginning of this debacle rumors of military intervention have circulated but the army has been persistent in quelling them probably marked by bad experience from its last attempt at ruling the country in 2006-2008. Observers have been musing that the courts can arrange a "judicial" coup if the army chooses to remain on the sidelines. Without deep knowledge of Thai law, it is hard to comment on how this could solve any problem. In the end, Thailand is a constitutional monarchy leaving the King with certain emergency powers. Notwithstanding high age he could eventually choose to intervene.

The likely next move? For bystanders it is hard to fathom what motivates the actions of the opposing players in this saga. Previously much attention was focused on a possible event seldom mentioned by name, but the importance of seems to have somewhat faded. A royal transition, should it take place, could also imply not only political but also economic changes. In this cloud of intransparency, unpredictability is "king". That could determine investor decisions in the absence of a near term political solution.

Outlook

The short to medium term outlook of Thailand is clouded by extraordinary uncertainty. 2014 will be a muddle through year, as the formation of a new functioning government is unlikely to come in time to support a recovery in the fall -- the basic assumption for many forecasts up to this point. As such we foresee the economy decelerate further to 2,5% growth. That will be the result of missing government expenditures with spill-over effects to domestic demand including construction and also the effect of reduced confidence among consumers and investors. Otherwise, risk analysis shows that Thailand has become quite vulnerable to outside shocks. (Confer Box 1)

Box 1: Risk scenarios



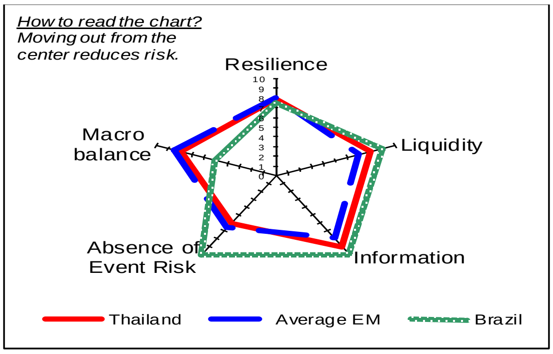
Based on the Oxford Model scenario analysis shows Thailand is clearly impacted by a hard landing in China following a system-wide banking crisis of that country which is Thailand's largest single country export market. This produces a slowing of Thailand's annual growth to less than 3% on average 2014-18 and a dip to below 1% in 2015.

A new bout of capital outflows from EM countries would also hit Thailand but less severely.

Better than expected US growth (about 0,5% higher average annual growth 2014-18) would only have a mild positive effect on Thailand.

Provided a fully functioning government takes office following due constitutional processes well before year-end, the base should have been laid for a proper recovery in 2015 with acceleration to potential growth around 5% in 2016. In that case there is a decent chance that Thailand could have put the experience of political turmoil of recent months behind. This is our medium term baseline scenario. In the less likely but still not extreme down-case scenario of continued political uncertainty without a proper government, muddle through can continue for a while but with increasing down-side risk including capital flight forcing the central bank to hike rates to defend the baht. That does not imply discounting the development of more severe situations although it is likely that the army eventually would step in before any outbreak of civil strife -- a prospect figuring in Thai media and the public according to recent opinion polls. However, a military takeover would be a stop-gap solution only, possibly with more uncertainty down the road.

Key ratios	**2014**
GDP/capita ($)	5512
GDP (change)	2.5%
Inflation	2.5%
Curr. Account balance/GDP	0.7%
Reserves/imports (months)	9
Budget balance/GDP	-3.3%
Central gov. debt/GDP	41%



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:	2009	2010	2011	2012	2013	2014	2015	2016
GDP (mill.US$)	264	319	346	366	388	384	399	416
GDP/capita (US$)	3894	4683	5043	5309	5592	5512	5705	5918
GDP (real change)	-2.3%	7.8%	0.1%	6.5%	2.9%	2.5%	4.2%	4.5%
Investments/GDP	20%	21%	21%	23%	22%	20%	21%	21%
Budget balance/GDP	-4.0%	-0.7%	-0.3%	-3.6%	-2.3%	-3.3%	-3.6%	-3.5%
Govt debt/GDP	28%	29%	29%	30%	31%	41%	42%	43%
CPI inflation (%)	-0.9%	3.3%	3.8%	3.0%	2.2%	2.5%	2.5%	2.5%
Money demand (%)	3.2%	3.4%	7.2%	20.9%	13.9%	4.7%	0.6%	3.4%
Stock prices (yearly avg.)	67797	68188	68576	68947	69303			
Interest rates	1.6%	1.6%	3.1%	3.1%	2.7%	2.6%	3.7%	4.7%
Exch. Rate ($)	34.29	31.69	30.49	31.08	30.73	32.60	33.48	34.41
Trade/GDP (%)	102%	111%	122%	122%	115%	120%	127%	136%
Oil price (Brent)	$62	$80	$111	$112	$109	$104	$103	$106
Millions US $								
Export of goods	150.8	191.6	219.1	225.9	225.4	235.3	260.3	289.4
Imports of goods	118.2	161.9	202.1	219.9	219.0	224.7	247.9	276.7
Other:	21.9	10.0	4.1	-1.5	-2.8	2.7	4.5	3.6
Current account	**21.9**	**10.0**	**4.1**	**-1.5**	**-2.8**	**2.7**	**4.5**	**3.6**
(% of GDP)	8.3%	3.1%	1.2%	-0.4%	-0.7%	0.7%	1.1%	0.9%
FDI	0.7	4.5	5.0	-2.0	6.2	-1.3	-0.6	1.0
Loan repayments	-11.3	-9.4	-8.8	-9.5	-22.0	-31.1	-34.8	-38.4
Net other capital flows	8.0	23.5	20.7	10.7	12.5	45.1	42.0	45.1
Balance of payments	**19.3**	**28.6**	**21.0**	**-2.2**	**-6.1**	**15.4**	**11.1**	**11.3**
Reserves (yearly avg.)	124.1	152.8	173.7	171.5	165.4	180.8	191.9	203.2
Total debt (yearly avg.)	72.9	89.0	108.3	121.2	141.5	149.9	155.4	164.2
o/w short term debt	30.5	42.8	53.5	55.9	64.6	74.7	76.9	81.1

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

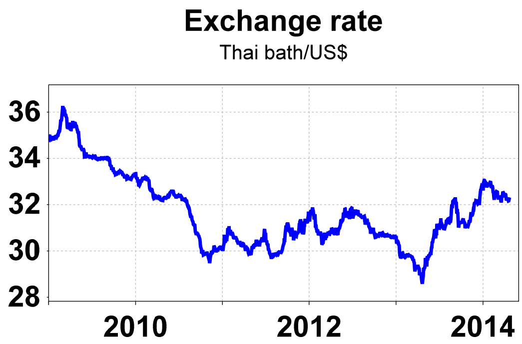
Type of government:

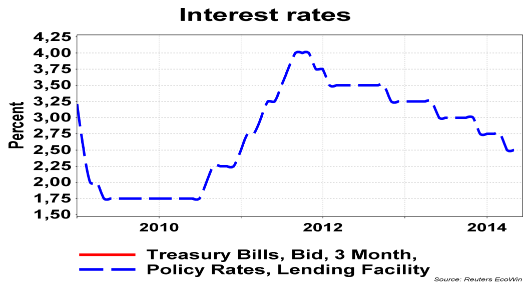
Next elections July 2015

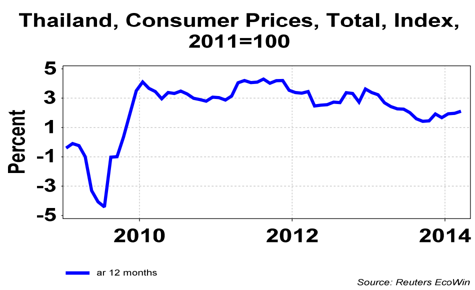
Other:

Latest PC deal None

Recent IMF programs Stand-by 1997







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