

Thailand: More rate cuts to come

DBS Group Research

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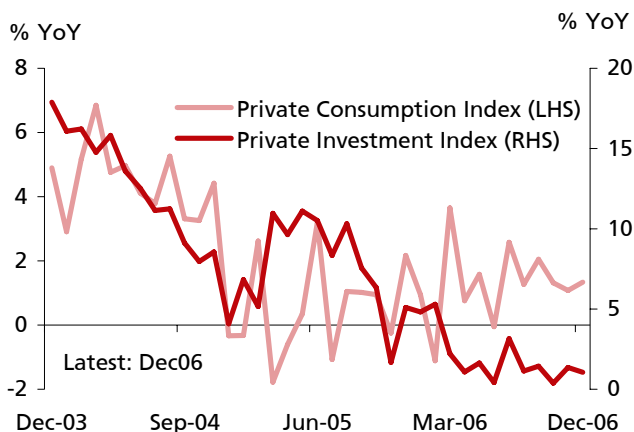
Summary

- The Thai economy still looks ruffled. Investor and business confidence indices are down, a reversal from the pickup in confidence recorded in the immediate aftermath of the coup. Private consumption and investment spending indicators are also heading south, again a reflection of the prevailing bearish sentiment. On a slightly more positive note, inflation is easing, and it is still possible that fiscal spending will rise as per the Budget, and that the election may go ahead in 4Q07.
- Inflation has been falling for the past few months and this enabled the BOT to cut rates once earlier this year. We believe that concern about consumer spending and investor confidence will bias monetary policy towards further accommodation. We expect another 25bp cut in the overnight repo rate when the MPC meets on Feb 28.

The four-month report card...

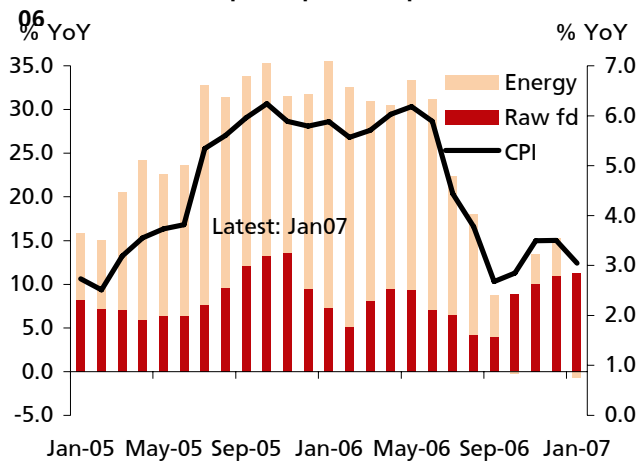
- What has happened in four months after the coup and the new military-backed civilian government was formed? Some messy policy changes, a few retractions, public confidence that has risen and then fallen, and the economy is still in the doldrums if not for the soaring exports. The picture looks bleak and is likely to remain so until budget spending and interest rate cuts instill a new sense of confidence in the economy. In the pipeline too are the rewriting of the Constitution and the promised of fresh elections this October. For the moment, we are not revising our growth forecasts for the year (5.1% YoY for 2007) based on the view that firstly mega-projects will kick-off as planned and secondly that the BOT's monetary easing will boost consumer spending. However, a review of DBS' GDP growth estimates will be made after Jan07 data are released later this month, as a better picture of the fallout from the BOT's capital control measures announced in December would then be available.
- In the meantime, we take a look at the data released by the BOT for Dec06. A comparison of the 4Q06 numbers with the other quarters in 2006 show that private consumption and investment fell (**Chart 1**). Although manufacturing showed a slight improvement in 4Q, growth was well below the 9.6% YoY registered in 1Q06. We note also that money supply, bank deposits and commercial bank credits have shown lower growth rates vis-à-vis the other quarters. On the other hand, exports continued to strengthen, whereas import growth was slower because of an easing oil prices as well as sluggish domestic demand. As such, the current account balance registered bigger surpluses on exports and higher tourist receipts.
- Manufacturing growth picked up in Dec06 to 7.0% YoY from 5.7% in October, bringing the fourth quarter growth to a respectable 6.9%. While capacity utilization remained at high 70-plus levels, expansion plans could be dampened by declining confidence levels and delayed investment projects from political uncertainty. At the same time, agriculture showed a contraction in output (2% YoY in 4Q against 7.7% in 3Q) and prices for major crops shot up (21.8% in 4Q against 18.7% in 3Q). This left an impact on inflation despite the falling world oil prices. Fourth quarter inflation largely reflected the higher food prices (**Chart 2**) due to the floods. Looking ahead, we expect inflation to ease to below-3% levels.

Chart 1: Both consumption and investment growth are down



Source: CEIC, DBS.

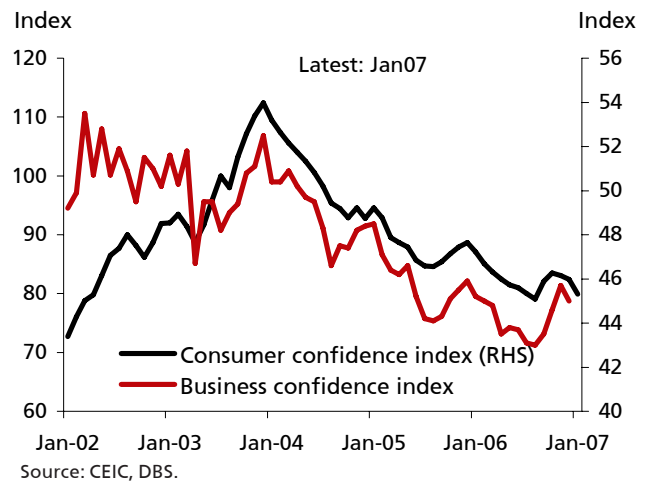
Chart 2: Raw food prices pushed up inflation in end-06



Source: CEIC, DBS.

- The sharp upturn in sentiment recorded soon after the coup did not last for long (**Chart 3**). The consumer sentiment index rose to 83.5 in Oct06, but fell to 79.9 in the month of Jan07. Business sentiment in the country followed suit. There are no surprises here, given the investor-unfriendly policies that the government had dished out in late-Dec06 and early Jan07. However, the economy is likely to have grown faster in 2006 than 4.5% in 2005, given the backing of strong export growth. The expansion in the trade surplus in 4Q was backed by strong exports and falling imports, and this resulted in a larger current account surplus. The latter was also helped by a reversal in net service income and transfers to surplus. We expect tourism to play an important role in boosting the current account surplus, as tourist arrivals rose 15.1% in Dec06, bringing the full year figure to a record 1.4mn.
- Not surprisingly, the baht's appreciation has raised fears amongst exporters and the small and medium enterprises. The strong baht, coupled with capital inflows for speculative gains were the oft-cited reasons that prompted the central bank to come out with measures to control the exchange rate. The BOT introduced its first measure – reserve requirement on short-term capital inflows – to reduce the baht volatility, which ironically led to volatility in the SET and a subsequent revision in the rule pertaining to foreign portfolio equity flows. After that, the New Year bombings and changes to the Foreign Business Act further shook investor confidence. This is likely to show up in the investment-consumption numbers for Jan07.

Chart 3: Confidence indices are down again



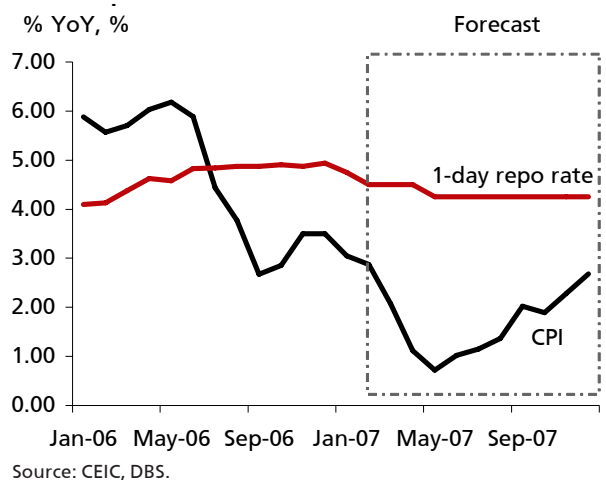
...and a silver lining!

- All bets are now placed on the pace of fiscal spending to revive consumer spending this year. The 2007 budget projects a deficit of THB 146bn (around 1.7% of GDP) on expenditures of THB 1.57trn and investment spending is expected to stimulate a pick-up in fiscal spending. The government and state enterprises are also expected to spend about THB 600bn to finance investments in mega-projects this year. To finance this, the Finance Ministry and state enterprises plan to borrow THB 150bn and THB 300bn respectively. Given that the priority of the government now is two-fold – boost consumer spending and to offset the declining investor confidence - we can expect a boost in the economy, if everything goes according to plan. Resuming work on the mega-projects would also imply a rising import bill, hence the trade balance is likely to slip into a deficit later this year.
- Meanwhile, there have been ongoing talks between the government and investors regarding the 30% reserve requirement measure. Therefore, it remains a possibility that it may exempt fully hedged investments in all types of funds from the capital controls, though the funds may still have to remain in the country for one year. The BOT governor also commented that “should the baht move steadily at an appropriate level”, the bank would be ready to terminate the measure.

More rate cuts to come

- Since the last policy meeting, the BOT has changed its policy target to the overnight repurchase rate and started off the year with a rate cut. Slipping confidence levels, a possibility of slow growth in the beginning of 2007 and easing inflation have given room for the BOT to cut rates. The one-day repo rate now stands at 4.75%.
- The BOT has initiated policy action a month earlier than expected. Recent rhetoric from the central bank have centered around consumer spending and moderate inflation, suggesting that further accommodation is on the cards. In all likelihood, the Monetary Policy Committee will move for another 25bps rate cut at the Feb 28 meeting. This would take the overnight repo rate to 4.50%.
- We note that the BOT has also revised down its economic growth projection for 2007 to 4.0-5.0% from 4.5-5.5% previously. Inflation forecast for the year has also been brought down to 1.5-2.5% from 1.5-3.0% earlier. While a pick-up in private and public investment because of faster-than-expected budget disbursements will provide the impetus for growth this year, we believe the BOT will continue easing monetary policy to improve people's purchasing power. Our inflation forecast for 2007 now stands revised at 1.9% YoY, on the mid-range of the BOT's forecast. We are hence revising our policy rate forecast to one 25bp cut on Feb 28 and another 25bp cut in 2Q. This would take the policy rate to 4.25% by mid-2007 (**Chart 4**).

Chart 4: Further easing in monetary policy



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