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ECONOMICS: ASIAN PERSPECTIVES

THAILAND HAS ROOM FOR FURTHER RATE CUTS

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Although the Bank of Thailand appeared to have finished cutting interest rates, we believe that renewed signs of economic weakness justifies a further easing. Political uncertainty will limit fiscal policy, and previous rate cuts have not filtered through into the economy. The local yield curve looks attractive, given that the recent bond sell-off was based on assumptions that there would be no more rate cuts.

Domestic Demand Slackens Again

The Bank of Thailand (BOT) took a pause after cutting its policy rate at its two previous policy setting meetings. The decision is believed to be based on anticipation that increased public spending and a recovery in tourism income would shore up the economy.

However, recent indicators suggest renewed weakness in growth momentum, while fiscal policy remains restrictive and the previous rate cuts have had a limited impact on reigniting credit demand so far. Against this background, we believe that a further monetary easing at some point will be justified.

Overall, there's a lack of organic growth drivers in the private sector. Weakness in major activity indicators—such as the BOT's own private consumption and investment indices, which closely track the corresponding components of gross domestic product (GDP)—all point to weakening sequential growth in the second quarter. Growth in imports of consumer durables and capital goods is tepid, and credit demand has been dormant.

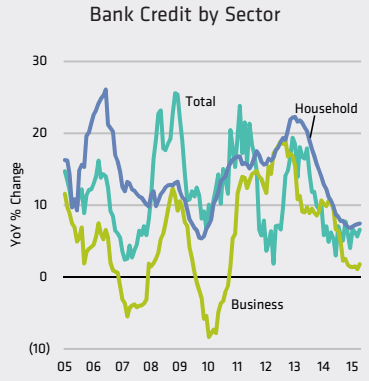
Thailand's investment cycle has historically been highly correlated with exports. This is because a majority of capital expenditure has been attributable to the manufacturing sector—unlike other ASEAN countries such as Malaysia, where public projects have played a greater role in driving the investment cycle (see "Stagnant Growth Calls for Further Monetary Easing" *Asian Perspectives*, April 17, 2015).

The capacity utilization rate has been capped below 60% in recent months, a level not seen since the massive floods in 2011 and the 2008 global financial crisis. Manufacturers therefore have little incentive to expand their capacity anytime soon, especially in the face of renewed weakness in exports across Asia.

Limited Transmission of Monetary Easing

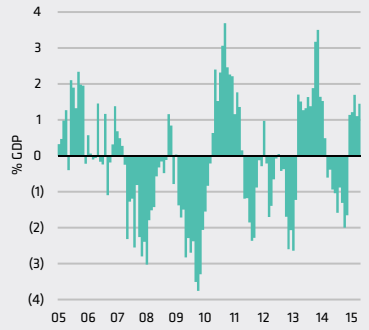
Even after the two BOT rate cuts, credit growth has continued to dwindle to recession-era levels (*Display 1*), implying that the policy easing has had a very limited stimulus effect. The impact of the rate cuts has been confined, at most, to baht (THB) weakness, which has helped to preserve the competitiveness of the export and tourism segments.

Display 1
Credit Demand Continues to Weaken



As of June 24, 2015
Source: CEIC Data and AB

Display 2
Fiscal Policy Still Restrictive



As of June 24, 2015
Source: CEIC Data and AB

For now, monetary conditions are already accommodative and tepid final demand remains the key constraint. In such a case, supply-side measures would be more effective in reviving growth. Yet, even though the government has vowed to accelerate disbursements for budgeted spending plans, we have so far seen little evidence that fiscal spending is supporting the economy.

Fiscal Policy Remains Restrictive

Overall, Thailand's fiscal policy remains restrictive. It is still in a consolidation mode, as suggested by a continued improvement of the budget position (*Display 2, previous page*). In addition, there has been no evidence of an increase in off-balance-sheet fiscal expenditure, which is commonly observed across Southeast Asia. Outstanding liabilities of state-owned enterprises (SOEs) and debt guarantees extended by the government have continued to decline for the past few years (*Display 3*).

Problems in executing budgeted government spending could be due to reluctance to disburse funds at the local government level. Political uncertainty persists after a constitutional reform and in the run-up to elections promised by the military government. Moreover, a high-profile anti-corruption campaign has made officials wary of procurements of any scale.

In the past, fiscal support initiatives, such as the rice program and loans for post-flood reconstruction, utilized the state-owned Specialized Financial Institutions (SFIs). But growth in SFI loans has moderated noticeably over the past few quarters.

Regional Factors Are Driving Baht

With an absence of a private sector growth driver and the continuation of a restrictive fiscal stance, sluggish domestic demand should keep constraining import growth and help sustain the current account surplus. Thailand's external position is also supported by an ongoing recovery in tourism and has received an extra boost from lower fuel prices. The country has one of the widest oil trade deficits in Asia.

The improvement in the current account is more than enough to offset the portfolio outflows, and the net balance-of-payment position has returned to surplus territory (*Display 4*). Nonetheless, even with the strengthened external position, the baht has been driven mainly by Asia-wide factors, rather than domestic elements such as the growth cycle or external positions. This is evidenced by the close correlation between the currency and the Bloomberg-JP Morgan Asia Currency Index, or ADXY (*Display 5*).

Investment Implications

Despite favorable fundamentals, the Thai currency is still restrained by external headwinds such as a weaker export outlook, a downcycle in Asia's economic growth, and potential market volatility due to a widely anticipated US Federal Reserve tightening.

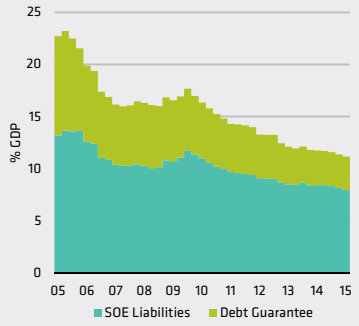
The silver lining is that any efforts by the BOT to weaken the baht will only have a temporarily impact and that the currency remains a well-tracked and easily tradable proxy for the regional currency basket that has limited domestic risk factors. The baht should become more appealing when the US dollar's strength begins to wane and foreign investors regain an appetite for Asian currency exposures.

Meanwhile, slackening growth momentum calls for further policy support. However, with the military government deliberately avoiding consumption-boosting measures—in a bid to differentiate itself from the populist image of the previous regime—and with officials remaining cautious about the anti-corruption drive, support from the fiscal side is likely to remain limited. Monetary policy, therefore, will be the primary tool to tackle any economic slowdown.

From the BOT's perspective, although the marginal effect of a further rate cut is diminishing, so is the economic cost of such an action. It helps that the current repo rate is still 25 basis points higher than its previous low in 2010. This means that the local yield curve is at an attractive level, since the recent bond market sell-off was based on the assumption that the BOT's easing cycle had come to an end.

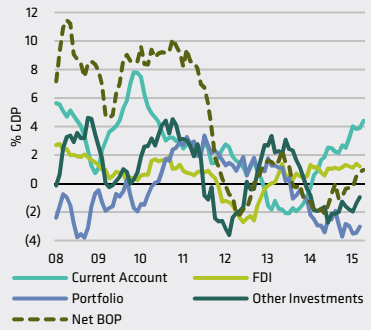
Looking ahead, we believe that the BOT will keep its powder keg dry for now and deliver any additional rate cuts when the baht strengthens against other Asian currencies or when the central bank becomes uncomfortable with the baht's levels against hard currencies. ■

Display 3
No Sign of Off-Balance-Sheet Fiscal Support



As of June 24, 2015
Source: CEIC Data and AB

Display 4
External Position Has Improved Since 2014



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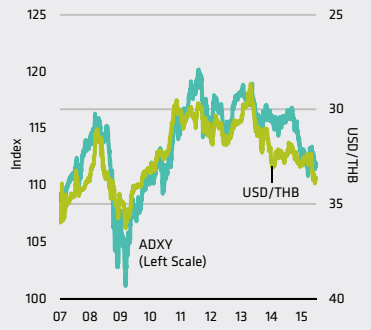
Source: CEIC Data and AB

Display 5
Regional Factors Are Driving THB



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