Emerging Markets

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Flood damage and growth revision

Supavud Saicheua +66 2 305 9193
Economist
Phatra Securities
supavud@phatrasecurities.com

Thanomsri Fongarunrung +66 2 305 9206
Economist
Phatra Securities
thanomsri@phatrasecurities.com

GDP growth downgrade

We cut our GDP growth forecast for 2011 and 2012 to 3.8% (from 4.1%) and 4% (from 4.5%), respectively. The downward revision for 2011 is based on the unfolding damage from the worst flooding in Thailand in 50 years. The current flood damage estimate by the government, at Bt30bn, is expected to rise further. We expect the flood damage could be as high as Bt50bn, or 0.5% of GDP.

Flooding damage

Currently, 28 provinces in the North, Northeast and Central areas are hard-hit by heavy rain and floods. The government estimated that the floods have cost Thailand more than 10% of its main rice crop harvest. The bigger threat is the way the floods have quickly moved down from the north and northeast, having now reached factories in the central region, where eight industrial estates are at risk from the floods. We are penciling in about Bt50bn, or 0.5% of GDP; this compares with the flooding in 1989, with over 400 reported deaths and damages amounting to 0.7% of GDP.

2012 growth cut to 4%, policy rate on hold

Our BofAML economic team has cut its global growth forecast by 0.5ppt, to 4%, in 2012 from a downgrade in US, Europe and Japan. Therefore, we cut our 2012 GDP growth forecast by 0.5ppt, to 4% (consensus is 4.6%). As the Bank of Thailand has now acknowledged more fully that the downside risk to global growth has risen, we now believe Thailand's monetary policy committee will keep the policy rate on hold at the current rate of 3.5% throughout 2012. The shift to the headline inflation target in 2012 will not, we believe, shift the practical application of monetary policy.

Risk factors

Exports and high agricultural product prices are key drivers of growth. An unexpected sharp slowdown in the G3 countries would directly and indirectly dampen exports and employment. Falling agriculture prices will result in a reduction in purchasing power. Unlike the situation in 2001 and 2009, we do not expect the BoT to promptly ease its monetary stance to support growth, given its concern over inflationary pressure caused by fiscal stimulus.

Table 1: Economic forecast

% YoY	2010	2011E	2012E
Real GDP	7.8	3.8	4.0
Private consumption	4.8	3.7	4.0
Public consumption	6.4	3.0	3.0
Gross fixed investment	9.4	6.3	7.1
Private	13.8	9.0	8.0
Public	-2.2	-2.0	4.0
Headline CPI	3.3	3.9	3.4
Exports	28.5	20.0	10.0
Imports	36.7	26.0	13.0
Current account ($ bn)	14.8	13.1	8.1
as % of GDP	4.2	3.5	2.0
Policy rate	2.00	3.50	3.50

Source: Phatra Securities

Refer to important disclosures on page 5. Link to Definitions on page 4.

GDP growth downgrade

We cut our GDP growth forecast for 2011 and 2012 to 3.7% (from 4.1%) and 4% (from 4.5%), respectively. The downward revision for 2011 is based on the unfolding damage from the worst flooding in Thailand in 50 years. The current flood damage estimate by the government, at Bt30bn, is expected to rise further. We expect the flood damage could be as high as Bt50bn, or 0.5% of GDP.

For 2012, we could see some lingering after-effects from the floods, largely offset by a boost in economic activity from reconstruction. However, our downgrade of 2012 GDP growth is predicated mainly on Europe expecting to grow less than 1% and increased risk, as evidenced by our US team's view that the probability of a US recession has edged up to 40%.

Flood damage estimate Bt50bn

Currently, 28 provinces in the North, Northeast and Central areas are hard-hit by heavy rain and floods. As of 5 October, 237 deaths have been reported, the most serious flood disaster in terms of lives lost since 1989 (excluding the 2004 tsunami, which was not specific to Thailand).

The government estimated that the floods have cost Thailand more than 10% of its main rice crop harvest, that is, a loss of about 3mn tons of paddy to 22.5mn tons. Other crop and livestock losses are not expected to be significant. We are, therefore, less concerned about losses in terms of agricultural output for three reasons. First, the govt. is already putting in place a generous rice-pledging scheme for rice, setting a guarantee price of Bt15,000 per ton of paddy (equivalent to over $800 per ton of milled rice versus the prevailing world price of $600 per ton). Second, the government has made it clear that farmers will receive compensation for rice crop losses. Third, too much water now means plentiful water in the dams. The increased supply of irrigated water to the central regions in 2012 will boost rice production in the second and third crops to be grown during 1H 2012.

The bigger threat is the way the floods have quickly moved down from the north and northeast, having now reached factories in the central region, where eight industrial estates are at risk. Of particular concern is the flash flooding in Ayutthaya, Thailand's old capital and now a major industrial zone for the production of auto and electronics parts. Honda (Thailand) announced a one-week suspension of its production because suppliers are unable to deliver the needed parts.

Ayutthaya altogether has 2,100 factories and is just 76km from Bangkok. The authorities reported that, as of 5 October, 46 factories are under almost two meters of water. Some factories may have to close for three months, up from the previous estimate of five days.

Given that heavy rains could continue to the end of October, with floodwaters and tides reaching their peak at the end of the month, current government damage estimates are subject to upside risks. For now, the government estimates damages amounting to about Bt30bn. We are penciling in about Bt50bn, or 0.5% of GDP. This compares with the flooding in 1989, with over 400 reported deaths and damages amounting to 0.7% of GDP.

Table 2: Gross Regional Product (Market Price)

	Bt bn	%
Northeastern	1,123	11.1
Northern	964	9.5
Southern	982	9.7
Eastern	1,631	16.1
Western	424	4.2
Central	805	8.0
Bangkok and Vicinities	4,177	41.3
Whole kingdom	10,105	100.0

Source: NESDB

Worst-case scenario

Normally, monsoon floods cause marginal damage to the main rice crop without any impact on industrial production, and rarely do the waters reach Bangkok. The worst-case scenario would, therefore, involve floodwaters disrupting industrial production in the central and eastern regions, as well as floods reaching Bangkok and affecting commerce and tourism in the Thai capital.

As seen below, the Eastern region, which has so far been unaffected by the floods, has the highest Gross Provincial Product (GPP), equal to 16% of GDP, because it is home to Thailand's manufacturing sector. During the past decade, more industries have moved to the Central region, which now contributes 8% of GDP. Output from these two regions is, however, less than half that of Bangkok, which accounts for 41% of GDP.

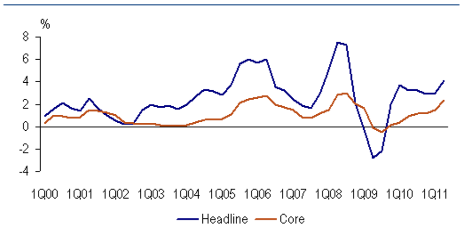
2012 growth cut to 4%, policy rate on hold

BofAML's economic team has cut its global growth forecast by 0.5ppt, to 4%, in 2012, from a downgrade in the US, Europe and Japan. Therefore, we have cut our 2012 GDP growth forecast by 0.5ppt, to 4% (consensus 4.6%). As the Bank of Thailand has now acknowledged more fully that the downside risk to global growth has risen, we now believe the Monetary Policy Committee will keep the policy rate on hold at the current rate of 3.5% throughout 2012.

BoT plans to target headline inflation in 2012

As part of its ongoing dialogue with the Ministry of Finance on various issues, the BoT said it now plans to shift its target from core inflation to headline inflation for 2012.

Chart 1: Headline CPI is more volatile than core

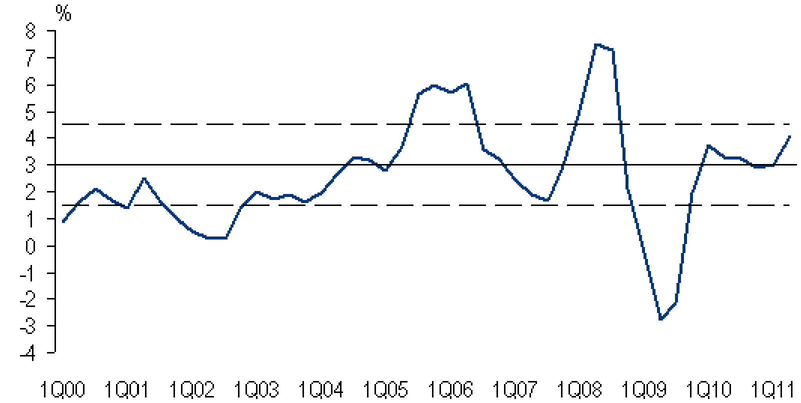


Source: MoC

Currently, the BoT's policy is to keep core inflation within 0.5-3%. This would be done by forecasting quarterly inflation and adjusting the policy rate to ensure that actual core inflation stays within this range. Since mid-2000, when this core inflation-targeting policy was implemented, core inflation averaged 1.1%, while headline inflation was 2.6%.

The new inflation target would be a point target set at 3% in 2012, allowing for deviations of up to plus or minus 1.5ppt. This deviation is wider than that adopted in other ASEAN countries. For example, Korea's headline inflation targets are 3%, plus or minus 1% and Malaysia set at 2%, plus or minus 1%. The BoT also said that this 3% target will be based on headline inflation data collected by the Ministry of Commerce, averaged over a 12-month period. This compares with the current system, in which core inflation is targeted on a quarterly basis.

Chart 2: Headline inflation is approaching the upper band of new target



Source: MoC

Would the more volatile headline inflation (versus core inflation) cause the BoT to adjust interest rates more frequently now that it targets headline inflation? The answer is likely to be no. This is because the BoT would now average headline inflation over a year period instead of having to target core inflation on a quarterly basis. Moreover, the plus/minus 1.5ppt margin gives the BoT greater room to maneuver than comparable central banks, as mentioned above. Given that Thailand is a small open economy that depends significantly on oil imports and agricultural exports, the BoT may actually have to respond more aggressively to externally induced hikes in world commodity prices now that headline inflation is being targeted. At the same time, given that prices tend to be sticky downwards, the same cannot be said of interest rate cuts.

Risk factors

Exports and high agriculture prices are key drivers of growth. An unexpected sharp slowdown in G3 would directly and indirectly dampen exports and employment. Falling agriculture prices will result in a reduction in purchasing power. Unlike the situation in 2001 and 2009, we do not expect the BoT to promptly ease its monetary stance to support growth, given its concern over inflationary pressure caused by fiscal stimulus. Moreover, if the baht continues to weaken against the US$, the BoT could be reluctant to cut rates aggressively for fear that further baht weakness would fan inflationary expectations, given that exports and imports amount to 135% of GDP.

Link to Definitions

Macro

Click here for definitions of commonly used terms.

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