

Thailand Economic Review
Fiscal Stimulus Needed Urgently

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EXECUTIVE SUMMARY

POLITICAL LANDSCAPE

The road out of Thailand's messy political stalemate is still strewn with obstacles. Two crucial issues at this time are how to restore the Election Commission's (EC) legitimacy and the outcome of lawsuits that could lead to the dissolution of the leading party TRT and a changed political landscape. Political risks are set to increase in the near term.

Numerous legal and constitutional issues need to be resolved to pave the way for a solution of the political problems. Judges from Thailand's three principal courts nullified the April 2 general election on May 8, declaring it was unconstitutional. The three courts also called for the resignation of EC commissioners to pave the way for a fresh and legitimate general election. But seven weeks have since passed and only one EC commissioner has resigned, while the three remaining members have continued to ignore strong criticism and heavy public pressure to cling onto office.

The TRT is alleged to have hired candidates for a handful of small political parties to contest the elections held in April. This was supposedly intended to circumvent the 20% rule i.e. if the TRT candidate was unopposed (as was the case in several southern constituencies), they would need to win at least 20% of votes from the eligible voters in that constituency to be elected.

If the TRT is found guilty of hiring bogus candidates to give a semblance of a genuine election this could result in its dissolution. Under article 69 of the organic law bills on political parties, it is stated that if a political party violates article 66 of the same organic law bills, the Constitutional Court can dissolve the guilty party.

If the TRT were to be barred for electoral fraud, all members of the party's management committee would be barred from setting up a new political party or taking any position in managing a new party for a period of five years.

Unless the aforementioned issues are dealt with effectively, setting a date for fresh elections would be difficult and it may take until next year before a new government is formed.

We expect the delay in approving the government's budget for FY07 to impact the economy in 4Q06-2Q07.

DOWNGRADING GDP ON POLITICAL UNCERTAINTY

We are lowering our 2006 Thai GDP forecast to 4% from 5.5% on political uncertainty, which we expect will delay investment recovery for three quarters at least. The risk is that the political uncertainty will last into 4Q06 or beyond and its impact on the economy will be greater than we currently expected.

The underlying trends in the economy are likely to continue as the high capacity utilization levels keep inflationary pressure high and interest rates rising. The export or domestic demand cannot keep up the growth and government driven stimulation is needed.

We are raising our inflation forecast to 5.5% from 4.5%. The Thai economy is operating near full capacity. We think energy-led inflation is likely to spread more than is generally expected. We expect the Bank of Thailand to raise the 14D repurchase rate to 6% by mid 2007.

Investment recovery is a necessary condition for the Thai economy to reverse the trend. That is unlikely to happen until the political uncertainty ends. We are not revising our 2007 forecast yet, because we



believe that the political uncertainty should dissipate by then. If the situation does not ease in the coming months, we may have to revise our forecast again.

REACHING FULL CAPACITY

Recent data suggest that the Thai economy has reached full capacity. Further growth requires capacity expansion through investment. The Bank of Thailand reported the capacity utilization level in mid 2006 at around 75%. The average capacity utilization in 2001/2 was 60%.

High capacity utilization changes inflation dynamics. The government believes that headline CPI inflation will fall sharply in 2H06 as energy prices level off on a year-on-year basis. This expectation may be too optimistic, in our view. As the political uncertainty delays capacity expansion, inflation could stay higher and last longer than the market expects.

The Bank of Thailand has kept real short-term interest rates negative for three years. This made sense during a period of low capacity utilization. However, as the economy reaches full capacity utilization, the central bank will need to keep real interest rates positive or risk inflation accelerating out of control.

CONSUMPTION, PROPERTY AND EXPORTS HAVE SLOWED

The retail sales index has been decelerating sharply for ten months. Rising energy prices are a major factor. Energy imports reached 11.8% of GDP in 2005, from 8.1% in 2004 and 6.3% in 2003. The extra money for energy bills has come out of consumption mostly.

Anecdotal evidence suggests that the housing market is cooling. The approvals for new property construction dropped by 13.6% in 2005, compared with a 22.2% increase in 2004. This suggests that property developers are anticipating slower property sales in a rising interest rate environment.

The government has announced its intention to invest THB200bn in low-cost housing over three years. Thailand badly needs affordable housing to improve housing conditions for the general population. The property market that affects macro conditions has little to do with the average citizen. As with other mega projects, we think the low-cost housing push will also be delayed.

POLITICAL UNCERTAINTY IS LIKELY TO DELAY INVESTMENTS

The political uncertainty in Thailand will last for another three quarters, we believe. The risk is that it lasts throughout the next year. The political uncertainty could considerably delay investment recovery, which is badly needed to sustain economic growth in a fully employed economy. The government has recently cut its predicted 1st phase THB250bn (3.5% of 2005 GDP) of investment into government-initiated mega projects to THB150bn due to political uncertainty. As that uncertainty has worsened considerably in recent days, we think the outlook for the mega projects in 2006 is now much dimmer.

In addition, private sector investment, especially that complementing the mega projects, could be delayed also. The cooling housing market has already slowed private investment considerably. The outlook for investment is quite poor this year, in our view.

One glimmer of hope is that Thailand's solid export performance could push the private sector to invest in building capacity regardless of the political environment. However, such a mitigating factor is unlikely to reverse the decelerating trends elsewhere.



STOCK MARKET

We remain a long-term bull on the Emerging Markets, especially East Asia versus G8 stock markets. Still the short-term risk in Thailand's SET is that it might fall on more political noise. Any such development should be viewed as a mid-term buying opportunity.

There is growing evidence that the Thai economy turned up decisively. The dramatic deleveraging which has occurred in Thailand since the 1997 Asian Crisis also means it is now time for another direct investment cycle. The Thai story has an increasingly exciting FDI component (<http://202.47.237.179:8080/news/partnership26jan49.wmv>).

Probable the best secondary market instrument available in this environment is the "SET Index Linked Capital Guaranteed Note" – few Notes have recently been issued at +100% index participation. Cumulate on the dips.

On the primary market, trading the basket spreads is now possibility. SET 50 Index futures were introduced in 28 April 2006 after 10 years of waiting. Short on the index and long on the selective export firms with a minimum 20% active carry.



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