Economics

DBS Flash

Thailand: Policymakers uncomfortable with baht strength

Economics/Growth/Policy/Rates/Thailand

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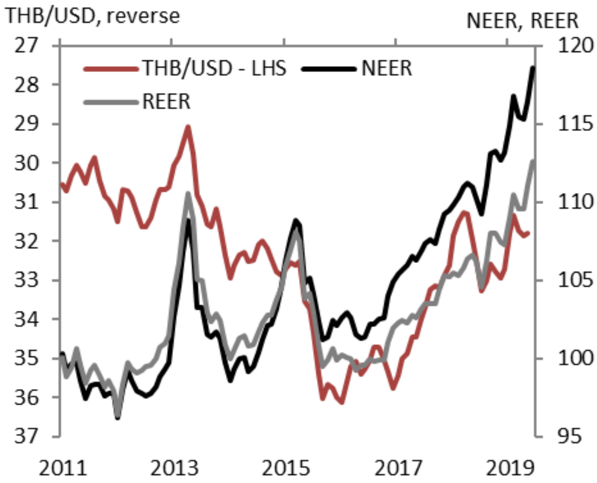
- *The Thai Baht (THB) is the regional outperformer, thanks to its safe-haven appeal*
- *Outlook upgrades by two rating agencies have added to its allure*
- *A strong baht is, however, inconsistent with Thailand's weakening economic fundamentals*
- *Factors beyond the authorities' control have contributed to this rally*
- *A rate cut might help but it will be no panacea*
- *Few non-rate measures have been initiated*
- *Implications for forecasts: We expect the BoT to monitor risks from a strong THB but not rush into policy easing*
- *Implications for investors: Policy action and USD strength may keep further THB gains in check*
- *Lower money market rates don't necessarily reflect easing expectations*

The Thai Baht (THB), which has appreciated 5.6% vs USD so far this year, **is the regional outperformer**. The Philippine peso and Indonesian rupiah ranked a distant next (~2.9%). The THB has rallied not only on the bilateral exchange rate, but also on effective exchange rate basis, up 5% in nominal and real terms.

USDTHB and effective exchange rates



Source: CEIC, DBS

This underscores the safe-haven appeal of Thai financial assets, backed by relatively firm external balances. Portfolio inflows into the debt and equity markets are up a cumulative USD3bn this year vs a small outflow in 2018. Interest in equities were also driven by changes in the Thai index's weighting in the MSCI EM Index last quarter, which led to higher allocations, lifting the benchmark index. **Encouraged by the clarity on the government formation, Fitch and Moody's raised Thailand's rating outlook from 'stable' to 'positive' in July.** Apart from the external balance, the agencies cited Thailand's favourable external creditor position vs other 'BBB' peers and transparency in fiscal spending towards infrastructure coupled with stronger fiscal position, as the economy's strengths.

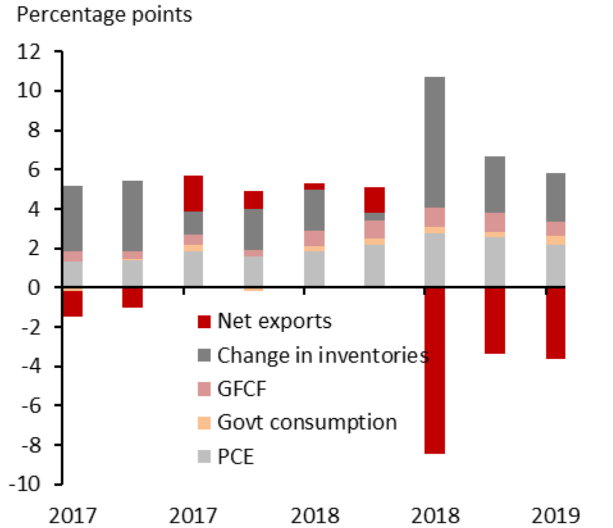
Foreign direct investment inflows into Thailand surged last year, more than those in the Philippines and Malaysia but less than Indonesia. Finally, persistent trade surpluses and service earnings through tourism receipts resulted in a current account surplus in 2018 of over 6% of GDP, compared to deficits or small surpluses amongst its regional peers.

A strong currency is, however, inconsistent with weakening economic fundamentals.

Real GDP started the year on a soft note; growth weakened to 2.8% YoY in 1Q19 (see here) from a revised 3.6% in 4Q18. If not for inventory accumulation, growth would have been weaker since 2H18. The year-long drag from net trade looks set to continue with the dim global trade outlook. We maintain our growth forecast at 3.4% YoY for 2019 vs 4.1% last year but see increasing downside risks.

THB strength also bodes poorly for exporters' revenues and trade competitiveness. A BOT study [1] revealed that a 1% strengthening of the baht against the USD increases export prices in US dollar terms by 0.3% on average, in the short-term. Further, the limited ability of manufacturers to pass costs of THB appreciation to export prices, implies that exporters will be hurt when these revenues are converted into baht. Lastly, a stronger baht squeezes corporate profits by narrowing the operating margin of export-oriented firms.

Growth weighed by weak trade (contribution)



Source: CEIC, data transformations is by DBS Group Research

Likely policy response

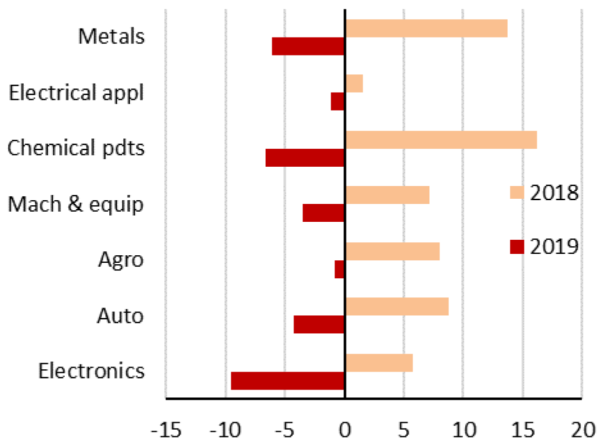
The Bank of Thailand has signalled its discomfort with a strong baht weighing on the growth/trade outlook. There is, however, little it can do, in a challenging global landscape, to control the safe-haven flows into attractive low-but-stable yielding Thai assets. **The BOT could consider a rate cut to help reduce the baht's yield appeal, but it will be no panacea**. A measured 25bp cut would simply undo last December's hike. Financial stability will become a concern if lower rates further lift household debt. Hence, **we expect the BOT to keep monitoring THB strength and not rush into policy easing.** Odds will rise if data continues to stay weak and THB appreciates past 30.50/USD and edges to 30.0 – six-year lows.

In the interim, few non-rate measures have been initiated. The outstanding balances of Non-resident Baht Accounts (NRBA) and Non-resident Baht Accounts for Securities (NRBS) have been lowered from THB300mn per non-resident to THB200mn to contain capital inflows. Non-residents holdings of debt securities will also be monitored more closely. Earlier this month, the BOT lowered July bond issuances, mainly comprising of 3 to 12-month papers, in a bid to curb speculative hot money flows into Thai short-dated notes.

Erstwhile support factors for THB to fade

Some relief is also likely from a moderation in drivers that drove THB gains. Firstly**,** the current account surplus looks set to narrow to sub-5% of GDP in 2019, after May's balance slipped into a deficit - a first since September 2014. Exports have declined -3% YoY in 1H19 led by a slowdown in key sectors, and more worryingly imports are down -2.4%, pointing to weakening domestic demand. At the same time, tourism receipts are also feeling the heat from slowdown in key host countries, which along with a strong THB have hurt collections.

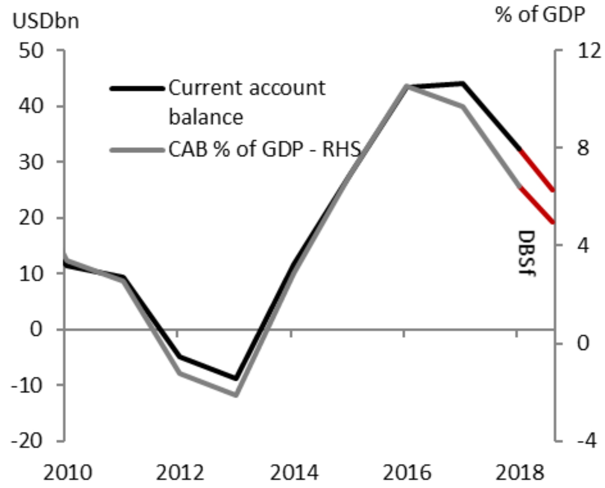
Exports breakdown YoY - top 7 sectors; ascending order



Source: CEIC, DBS

Considering these weak trade trends, together with a challenging outlook for regional growth/ trade outlook, a strong currency comes at an inopportune time.

Current account surplus to come off highs



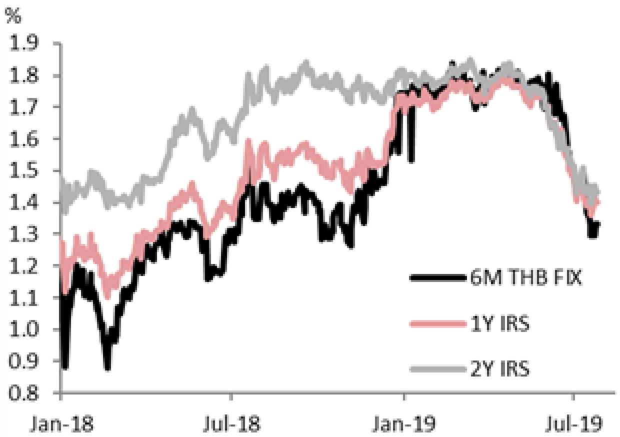
Source: CEIC, DBS

Secondly, if US dollar strengthens along our expectations (due to positive policy differentials vs G3), this will help contain THB gains here on. DBS FX Strategist expects USDTHB to rise beyond 31.50 by year end.

Thai rates – lower money market rates don't necessarily reflect easing expectations

With pressure building on BoT to start signalling easier policy, investors are keen to know 1) how many cuts are already priced in, and 2) how much lower can Thai rates fall if BoT starts to cut. The answer to both can be difficult to ascertain. The key 6M THB FIX rate (implied from FX forwards) is presently at 1.30% and very low relative to the 1.75% policy rate. However, a large part of that negative spread could be reflecting THB strength rather than rate cut expectations. If we assume markets expect THB strength to wane over a longer time period, 1Y and 2Y IRS rates appear to be pricing for BoT to stay on hold in the near term.

IRS markets seem to have priced out rate hikes.



Source: Bloomberg

10Y Thai government yields could be interesting to watch. For all of 2018 and most of 2019, those yields have traded below 10Y US Treasury (UST). Looking forward, that relationship could reverse (i.e. 10Y Thai yields trading above UST would be the norm). With US Fed expected to cut rates more than BoT, US-Thai short-term rate differentials should compress (become less positive). As an equalizer, we think long-term Thai yields (e.g. 10Y) would need to move higher vs UST to maintain relative attractiveness from a FX-hedged yields perspective.

Notes:

[1] Bank of Thailand, Monetary Policy report, June 2018

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).