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Asia Monitor

South East Asia Vol 1

BUSINESS MONITOR international

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VIETNAM

SBV To Allow More Foreign Participation

BMI View: Rising debt-servicing costs are leading to a rise in non-performing loans as small businesses struggle to remain profitable in an uncertain economic environment. We are optimistic about the government's efforts to consolidate small commercial banks, and we believe that foreign ownership rules could be eased further to allow greater foreign participation in the banking sector. Although our long-term outlook on Vietnamese banks remains positive, economic uncertainties in the near term suggests that banking stocks should continue to underperform the broader equity index over the coming months.

The State Bank of Vietnam (SBV)'s decision to implement another 100 basis points worth of rate hikes to bring its policy rate from 14.00% to 15.00% on October 10 should translate into higher debt servicing costs for businesses over the coming weeks. We see increasing risks that profit margins for small and medium-sized enterprises (could be squeezed as production costs remain elevated on the back of double-digit inflation, while rising debt servicing costs put further pressure on profits. Small businesses that are operating on thin profit margins, and poor liquidity in particular, could struggle to cope with higher interest rates and risk defaulting on their debt payments. The Vietnamese government has warned that non-performing loans (NPL) could rise significantly if economic conditions deteriorate over the coming months, a threat that could in turn undermine the stability of the banking system. As the

...continued on page 2

THAILAND

Heightened Risk Of A Recession

BMI View: We have downgraded Thailand's real GDP growth forecast from 3.6% to 1.5% for 2011 in light of the economic damages brought on by the recent floods. Although we expect to see a rebound in economic activity in H112 on the back of reconstruction efforts, external demand should remain depressed due to deteriorating global economic growth. Thus, we are maintaining our forecast for a subdued real GDP growth of 4.0% for Thailand in 2012. We warn that the threat of a collapse in external demand could easily tip the country into a recession.

We expect Thailand to see a year-on-year contraction in real GDP growth in Q411, following a weaker-than-expected reading of 3.5% y-o-y in Q311 (compared to consensus estimate of 4.5%). Recent floods have resulted in logistical bottlenecks for the manufacturing sector

...continued on page 4

THIS MONTH'S TOP STORIES

REGIONAL INDICATORS

South East Asia Indicators	2009	2010e	2011f	2012f
Nominal GDP, US$bn	1,457.8	1,805.3	2,071.1	2,218.7
Population, mn	536.8	542.9	549.1	555.3
GDP per capita, US$	2,716.0	3,325.0	3,771.7	3,995.8
Real GDP growth, %	1.4	7.8	4.9	4.8
Inflation, %	2.6	4.1	5.3	4.4
Goods Exports, US$	801.4	1,037.4	1,184.6	1,259.1
Goods Imports, US$	700.0	923.0	1,071.7	1,155.0

Notes: e BMI estimates. f BMI forecasts. 1 Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand, Vietnam. Data correct when forecasts were published.; 2 Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand, Vietnam. Data correct when forecasts were published. Weighted by nominal GDP; 3 Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand, Vietnam. Data correct when forecasts were published. Weighted by nominal GDP. Sources: 4 BMI.

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RISK SUMMARY

POLITICAL RISK

Tighter Supervision On SOEs

The Vietnamese government has pledged to boost efforts in the supervision and implementation of public investment. Prime Minister Nguyen Tan Dung assured the National Assembly on November 25 that public investment projects will be strictly monitored to ensure that they are being effectively implemented. He also reiterated the government's determination to restructure state-owned enterprises (SOE) to improve operational efficiency. We are optimistic that these efforts will help to prevent delays in public projects going forward. Allowing foreign investors to participation in public projects is also becoming an attractive option for the government.

Our short-term political rating stands at 76.9

ECONOMIC RISK

FDI To Cool In 2012

According to figures published by the Foreign Investment Agency, foreign direct investment (FDI) is estimated to reach US$12.7bn in the first 11 months of 2011. A total of 324 existing projects received the government's approval to receive additional investment capital of a combined total of US$2.8bn during this period. Hong Kong remained the country's largest source of FDI inflows, followed by Singapore and Japan. We see increasing risks that cooling FDI inflows over the coming quarters could result in weaker economic growth in 2012.

Our short-term economic rating stands at 53.1

BUSINESS ENVIRONMENT

Tough Times Ahead For Automobile Sector

Industry leaders are becoming increasingly concerned over Vietnam's competitiveness in the automobile sector. Industry experts believe that many foreign investors in the automobile sector are planning to exit the industry, leaving only three dominating foreign players in the country by 2018. We note that by 2014, import tariffs that apply to ASEAN members will need to be reduced by 50% due to Vietnam's commitment as a member of economic bloc. We believe that the reduction of these tariffs could cause domestic automobile manufacturers to struggle to compete effectively with imports from the region.

Our business environment rating stands at 45.2

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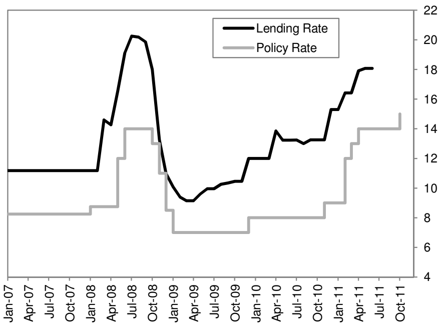
accompanying chart shows, NPLs across the four largest listed commercial banks in Vietnam remain low historically. However, we believe that NPLs across smaller commercial banks could be much higher.

Putting More Pressure On BusinessesReal

Vietnam – Lending Rate & SBV Policy Rate, %



Source: State Bank of Vietnam, BMI

Consolidation In The Banking Sector

In what we see as a move to recapitalise Vietnamese commercial banks to strengthen their balance sheets and reduce the risk of a banking crisis, the SBV is reviewing plans to consolidate small ailing banks through mergers and acquisitions. Given that Vietnamese banks remain undercapitalised in comparison with regional banks, the move has attracted positive responses from rating agencies and investors. From our standpoint, the government's decision to consolidate small commercial banks will be beneficial for the banking industry's development. Firstly, this will provide economies of scale for these banks to compete more effectively against their larger counterparts and foreign banks. Secondly, we believe that consolidation of the banking sector will serve as an effective way of eliminating uncompetitive banks through an orderly process, compared with elimination through a slow and disruptive process of allowing banks to exit the industry over time.

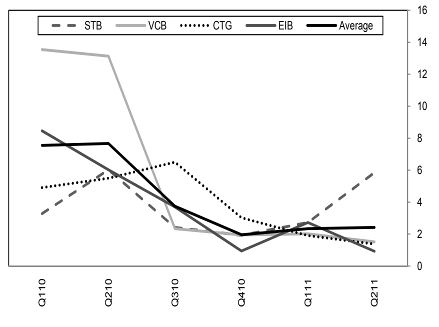
Greater Foreign Participation By Easing Foreign Ownership Rules

Back in February, we mentioned that increased foreign participation in the banking sector could benefit the industry through the transfer of skills and knowledge on international accounting and management practices (see 'Foreign Competition Forcing Banks To Catch Up', February 15). We believe that the SBV may ease foreign ownership rules to allow foreign banks to take a larger share in local commercial banks, a move that would speed up the sector's development, in our view. According to a report published by **Fitch Ratings**, deals that are currently in consideration include the International Finance Corporation's proposed 10% stake in Vietnam Joint Stock Commercial Bank for Industry and Trade (another 15% stake reportedly being considered by **Bank of Nova Scotia**), and a 15% stake in Joint Stock Commercial Bank for Foreign Trade of Vietnam by **Mizuho Corporate Bank**. Other commercial banks are also considering plans to raise more capital through issuing equity.

We believe that easing foreign ownership rules further should attract more foreign investors and pave the way for more deals over the coming quarters. A lack of economies of scale due to a small market share mean that small commercial banks will face significant difficulties in attracting foreign investors. Thus, we see the Vietnamese government's decision to consolidate small commercial banks as a positive move that will support efforts to speed up the development of the banking sector. This is a crucial element that will help local banks stay competitive as Vietnam continues to open up its banking sector to foreign competition over the coming years.

No Warning Signs... Yet

Vietnam – NPLs Of Selected Commercial Banks, %



Source: State Bank of Vietnam, BMI

Banking Stocks Set To Underperform

Despite our positive long-term view on Vietnamese banks, we warn that economic uncertainties in the near term continue to present significant downside risks to the sector's performance over the coming months. Risks of rising NPLs among smaller commercial banks could potentially have a ripple effect on the broader banking sector. Thus, we believe that banking stocks will continue to underperform the broader Ho Chi Minh Index over the coming months. On the other hand, cheap valuations also suggest that banking stocks could outperform by a significant margin when economic conditions in Vietnam start to improve, and we would view any meaningful weakness as a good long-term opportunity for investors.

POLITICAL OUTLOOK

Stronger Measures To Fight Corruption

BMI View: Despite slow progress, the government remains fully committed to its agenda on eradicating corruption. We remain optimistic that plans to implement a draft law to combat money-laundering activities, publishing information on personal property of public servants and formalising the legal responsibilities of government entities, should help support existing efforts to deter graft. Success in tackling corruption should reinforce confidence in the Communist Party of Vietnam's leadership and boost its credibility in pushing forward with further political reforms over the coming years.

Efforts by the Vietnamese government to address corruption have achieved limited success in recent years. Global political uprisings in recent months, many of which have been fuelled by public unrest in authoritative and corrupt governments, highlight the urgency in addressing corruption in Vietnam.

According to **Transparency International**'s 2010 Corruption Perceptions Index, Vietnam ranks 116 out of 178 countries, placing it at the bottom half of the group. This, in comparison with the country's ranking of 120 out of 180 countries in 2009, highlights the sluggish pace at which the country is progressing in terms of eradicating corruption. Despite the modest improvement, we are seeing positive signs that the Vietnamese government remains fully committed to fighting corruption. In October, high-level government officials attended the Conference of the State Parties to the UN Convention Against Corruption to discuss measures that the government is looking to implement over the coming months. These include a draft law to combat money-laundering activities, plans to publish information on personal property of public servants, and formalising the legal responsibilities of government entities. We are optimistic that the implementation of these measures will help support existing efforts to deter graft.

Addressing corruption should remain a priority on the government's agenda over the coming years. We note that an aggressive stance on fighting corruption is consistent with the government's goals on the economic front. We see widespread corruption as a major deterrent to foreign investment in the country. Thus, reducing corruption will benefit the overall economy in terms of promoting fair competition and promoting foreign direct investment (FDI) inflows into the country. Being fully aware that eradicating corruption will be crucial to the economic and political outlook for the country, the Vietnamese government is stepping up efforts to deal with the problem.

Over the longer term, we note that Vietnam possesses similar characteristics and traits of countries that have experienced major political uprisings in recent years. Vietnam adopts a single-party political system, which we see as inherently unstable over the long run. The government's absolute commitment towards maintaining its ideology of a single-party state has often resulted in the oppression of political dissidents over the years. This, in turn, has served as a catalyst for growing political dissent. Furthermore, high double-digit consumer price inflation, especially in the form of food prices, has placed severe strain on families among the lower-income population. Mismanagement of economic policies by the government, which are hurting the lower income segment of the population, is a recipe for political unrest, in our view. However, we note that success in tackling corruption would represent a major step in reinforcing confidence in the CPV's leadership. This would boost the CPV's credibility in pushing forward with further political reforms.

DATA & FORECASTS

BMI View : Vietnamese trade export growth came in at 29.5% y-o-y in November, outpacing import growth of 17.1% y-o-y. Resilient exports resulted in a subdued trade deficit of US$0.7bn in November. However, we warn that a deteriorating outlook on external demand means exports could start to ease over the coming months, undermining the government's efforts to bring the trade deficit back into balance. Thus, we maintain our forecasts for the trade deficit to remain high at 7% and 6% of GDP in 2011 and 2012, respectively.

	2009	2010	Latest Period		2011f	2012ff
Population, mn [3]	86.9	87.8	-	-	88.8	89.7
Nominal GDP, US$bn [4]	92.8	103.3	-	-	121.7	148.8
Nominal GDP, VNDbn [4]	1,658,389.0	1,980,914.0	-	-	2,506,361.1	3,031,263.6
GDP per capita, US$ [4]	1,068	1,176	-	-	1,370	1,658
Real GDP growth, % chg y-o-y [4]	5.3	6.8	6.1	Q311	6.0	6.5
Industrial production index, % y-o-y, ave [1,5]	6.7	14.1	-	-	14.0	15.0
Budget balance, VNDbn [6]	-108,722.0	-87,725.0	-	-	-74,356.4	-43,290.0
Budget balance, % of GDP [6]	-6.6	-4.4	-	-	-3.0	-1.4
Consumer prices, % y-o-y, eop [2,5]	6.5	11.8	-	-	20.0	8.0
Central Bank policy rate, % eop [7]	9.00	9.00	-	-	15.00	11.00
Exchange rate VND/US$, eop [8]	18,479.00	19,498.00	21,005.00	Nov	20,650.00	20,100.00
Goods imports, US$bn [9]	65.4	79.3	9.3	Nov	87.2	96.8
Goods exports, US$bn [9]	57.1	72.2	8.6	Nov	78.7	87.3
Balance of trade in goods, US$bn [9]	-8.3	-7.1	-0.7	Nov	-8.5	-9.5
Current account, US$bn [9]	-6.0	-4.3	-	-	-5.7	-6.6
Current account, % of GDP [9]	-6.5	-4.1	-	-	-4.7	-4.4
Foreign reserves ex gold, US$bn [9]	16.4	17.5	-	-	20.1	22.9
Import cover, months g&s [9]	3.1	2.6	-	-	2.8	2.8
Total external debt stock, US$mn [10]	28,673.8	31,407.3	-	-	34,276.6	37,131.9
Total external debt stock, % of GDP [10]	30.9	30.4	-	-	28.2	25.0

Notes: e BMI estimates. f BMI forecasts. 1 at 1994 prices; 2 Base year 2000; Sources: 3 World Bank/UN/BMI. 4 Asian Development Bank, General Statistics Office; 5 General Statistics Office; 6 Asian Development Bank, Ministry of Finance; 7 State Bank of Vietnam; 8 BMI; 9 Asian Development Bank; 10 World Bank.

RISK SUMMARY

POLITICAL RISK

Sticking To Its Promises

Prime Minister Yingluck Shinawatra and her recently formed coalition government have pledged to push ahead with the recent minimum wage hike and rice price guarantee scheme. The move was widely expected given that withdrawing subsidies during a time when the country is suffering from the worst floods in decades would be politically unfavourable. We expect further subsidies from the government to assist the lower-income groups in severely affected regions. Doing so should also help gather political support for the government following a wave of criticism over the mishandling of the crisis.

Our short-term political rating stands at 65.4.

ECONOMIC RISK

FDI Inflows To Remain Weak

Domestic commercial banks are keeping an optimistic outlook for foreign direct investment (FDI) inflows into Thailand despite the recent floods, which have fuelled fears that manufacturers could seek to diversify their operations overseas. Executive Vice-President of Kasikornbank Pakorn Partanapat said during a media interview that Thailand remains competitive in attracting foreign investment due to the country's economic fundamentals, infrastructure and skilled labour. However, we are taking a more cautious view on FDI. We expect inflows to remain weak in 2012 as stubborn global economic headwinds continue to keep investors at the sidelines.

Our short-term economic rating stands at 71.3.

BUSINESS ENVIRONMENT

Consolidation In Brokerage

Small and medium sized securities companies have expressed concerns over the planned liberalisation of brokerage industry in 2012. Chief Executive Officer of Asia Plus Securities Kongkiat Opaswongkarn warned that securities companies that have failed to diversify into other businesses besides providing brokerage services, could struggle to survive going forward. He added that many of these small companies rely heavily on brokerage fees, which is expected to thin on increased competition over the coming years. We believe that this could pave the way for a consolidation in the brokerage industry in 2012.

Our business environment rating stands at 62.2.

...continued from bottom of front page

and forced factories to close down in severely affected regions. Latest trade figures, also showed that exports had already begun to stagnate in the months prior to the flooding, further heightening our concerns that external demand could turn out to be weaker than we initially anticipated. Recent developments suggest further downside risks to our real GDP growth forecast of 3.6% for 2011, which is below Bloomberg consensus of 4.0%. Accordingly, we have downgraded our 2011 real GDP growth forecast from 3.6% to 1.5%.

Although we expect to see a rebound in economic activity in H112 – largely as a result of reconstruction efforts by the government – we caution that external demand could remain depressed due to the escalating sovereign debt crisis in eurozone. This is in line with our global team's recent downward revision of eurozone growth for a recession next year. Taking into consideration that a boost to growth from reconstruction efforts would be offset by sustained weakness in external demand, we are happy to maintain our forecast for a subdued real GDP growth of 4.0% for Thailand in 2012.

Households To Cut Back On Consumption

We see increasing risks that households could begin to cut back on consumption. According to the National Economic and Social Development Board, flood damages are expected to reach an estimated THB300bn (US$9.7bn). The sheer scale of these damages and the resulting impact on household wealth should prompt individuals to cut back heavily on luxury goods.

FDI Inflows Could Wane Amid Growing Risk Aversion

Reconstruction efforts spearheaded by the Thai government should provide a temporary boost to gross fixed capital formation (GFCF) growth over the coming months. We expect a large portion of new investment projects next year to be targeted at rebuilding infrastructure and properties. Meanwhile, private sector investment in expanding production capacity should be relatively weak given a bleak outlook for exports. Also, companies are likely to rely on their cash balances to restore production rather than expanding capacity. On the whole, we see a mild moderation in GFCF growth from 3.6% in 2011 to 3.5% in 2012.

Public Spending To Pick Up On Reconstruction Efforts

Earlier this month, the Thai government approved a THB11bn (US$0.4bn) flood-relief plan to compensate 2.3 million households that were affected by the recent floods. Given that there is a good chance that flood damages could exceed the government's estimates, we do not rule out the possibility that the authorities may have to extend further assistance and welfare subsides to households and businesses. Consequently, we expect public spending to pick up over the coming months (we are pencilling in public spending growth of 3.5% next year). Even without the extension of additional subsidies, reconstruction spending alone will result in a material fiscal budget deficit for 2012. We are sticking to our forecast for the fiscal deficit to reach 3.9% of GDP in 2012. However, we would consider raising our forecast should actual flood damages significantly exceed the government's estimates.

Net Exports A Key Drag On Growth

Net exports should remain a key drag on Thailand's economic growth over the coming quarters. In the months prior to the floods hitting key industrial zones in Thailand, we were already witnessing a flattening of trade export growth. Latest trade figures published by the Bank of Thailand showed that trade export growth slowed significantly from 31.1% y-o-y in August to 19.1% y-o-y in September and we expect the slowdown to continue into 2012. With economic headwinds still lingering in the US, China and eurozone, we are sticking to our view that external demand will continue to cool over the coming quarters. Our bleak outlook for exports is reflected in our forecast for a 2.4% trade deficit in 2012. We see export growth slowing to a low 3.6% next year, resulting in a negative contribution of 0.2% to overall growth in 2012.

Risk To Outlook

We believe that risks to Thailand's growth remains skewed towards the downside. A combination of factors including the potential for a break-up of the eurozone, risk that an imploding property bubble in China and a sputtering economic recovery in the US, present significant downside risks to Thailand's economy. Given that the Thai government is already stretching its ability to run an even larger fiscal deficit, we see few bright spots for the economy. The threat of an external blow to Thailand's economy could easily tip the country into a recession and we warn that this is not a remote possibility given that the global economy looks set to deteriorate over the coming quarters.

ECONOMIC OUTLOOK

Rate Cuts Could Come Early In 2012

BMI View: Recent floods have exacerbated downside risks to Thailand's economic growth, and we believe this should prompt the Bank of Thailand (BoT) to keep its policy rate on hold at 3.50% throughout the year. We note that rate cuts may come early in 2012 given that the BoT has signalled its intention to downgrade its real GDP growth forecast, a move that we see as a precursor for monetary easing (we are pencilling in 50 basis points worth of rate cuts next year). Meanwhile, inflationary pressures should continue to cool on the back of an expected slowdown in private sector credit growth and stabilising commodity prices.

The Bank of Thailand (BoT) has decided to keep its benchmark policy rate (one-day repurchase rate) on hold at 3.50% as the worst floods in decades threaten to exacerbate downside threats to economic growth. Six out of seven members of the central bank's Monetary Policy Committee supported the decision to keep interest rates on hold during the latest policy rate meeting on October 19. We believe that mounting downside risks to Thailand's economic growth could prompt the BoT to take a more dovish stance over the coming quarters.

Rate Cuts On The Way?

Although inflation could remain stubborn as supply disruptions put upward pressure on prices, we see growing risks that monetary easing could come much sooner than anticipated as the BoT attempts to provide support for the economy. The BoT has recently raised its estimates on damages caused by the floods, claiming that the total cost on the economy could reach as much as THB120bn (US$3.9bn), much higher than its previous estimates of THB60-80bn (US$1.9-2.6bn). BoT Governor Prasarn Trairatvorakul issued a statement on October 14 hinting that the central bank could downgrade its real GDP growth forecasts over the coming weeks. We see this as a strong signal by the central bank that it is ready to ease monetary policy to provide support for the economy.

Private Sector Credit Set To Cool

We note that previous monetary tightening by the BoT (the central bank has introduced 225 basis points worth of rate hikes since mid-2010) has failed to cool credit expansion. During this period, M2 money supply growth has actually risen from 6.9% y-o-y in June 2010 to 17.5% in August 2011. Although stubborn money supply growth continues to pose as a threat to inflation, we expect private sector credit growth to cool on the back of an expected slowdown in economic activity over the coming months. This, coupled with falling commodity prices, should help tame inflationary pressures over the coming months.

Furthermore, consumer price inflation (CPI) has remained relatively stable in recent months. Latest figures published by the BoT showed that headline CPI slowed from 4.3% y-o-y in August to 4.0% in September. Meanwhile, producer price inflation also slowed significantly from 6.0% to 5.6% during the same period.

We are convinced that headline CPI should continue to ease over the coming months to average around 3.5% and 3.0% in 2011 and 2012 respectively. Given that downside risks to growth should overshadow the BoT's concerns over inflation, we believe that risk to our outlook on interest rates are skewed to the downside. For now, we are sticking to our view that we would see 50 basis points worth of rate cuts in 2012.

DATA & FORECASTS

BMI View: The baht came under further selling pressure in November, mainly due to the sovereign debt crisis in the eurozone and the resultant fall in external demand. The currency depreciated by around 1.9% in November to trade at THB31.29/US$ at the time of writing. Despite the country's strong current account position, we believe that the Thai baht could witness further selling pressure over the coming months. We are pencilling in a further weakness in the currency towards THB33.00/US$ by end-2012.

	2009	2010	Latest Period		2011f	2012f
Population, mn [1]	67.8	68.1	-	-	68.5	68.9
Nominal GDP, US$bn [2]	263.9	315.8	-	-	335.9	343.8
Nominal GDP, THBbn [2]	9,047.6	10,010.4	-	-	10,456.5	11,209.0
GDP per capita, US$ [3]	4,077	4,634	-	-	4,903	4,992
Real GDP growth, % chg y-o-y [3]	-2.5	7.8	3.5	Q311	1.5	4.0
Industrial production index, % y-o-y, ave [2]	-9.0	6.0	-	-	4.5	4.5
Budget balance, THBbn [2]	-364.6	-99.8	-	-	-324.8	-454.6
Budget balance, % of GDP [4]	-4.0	-1.0	-	-	-3.1	-4.1
Consumer prices, % y-o-y, eop [2]	3.5	3.0	-	-	3.5	3.0
Central Bank policy rate, % eop [3]	1.25	2.00	-	-	3.50	3.00
Exchange rate THB/US$, eop [5]	33.42	30.03	31.32	Nov	32.20	33.00
Goods imports, US$bn [2]	131.4	179.6	21.3	Sep	212.7	219.9
Goods exports, US$bn [2]	150.7	193.7	21.5	Sep	222.5	227.0
Balance of trade in goods, US$bn [2]	19.4	14.1	0.2	Sep	9.8	7.1
Current account, US$bn [2]	21.9	14.8	-	-	10.6	8.1
Current account, % of GDP [4]	8.3	4.7	-	-	3.2	2.3
Foreign reserves ex gold, US$bn [6]	135.0	167.5	173.5	Oct	174.2	179.5
Import cover, months g&s [4]	10.4	9.7	-	-	8.6	8.5
Total external debt stock, US$mn [3]	75,306.7	96,912.8	-	-	101,373.9	105,848.5
Total external debt stock, % of GDP [4]	28.5	30.7	-	-	30.2	30.8

Notes: e BMI estimates. f BMI forecasts. Sources: 1 World Bank/UN/BMI. 2 Bank of Thailand, BMI; 3 Bank of Thailand; 4 BMI Calculation; 5 BMI; 6 IFS/BMI.

RISK SUMMARY

POLITICAL RISK

Budget Passed Amid Boycott

Cambodia's 2012 budget passed through the National Assembly on November 24 unopposed, with 86 votes in favour and none against. However, this absolute majority was due to blanket boycotts of the session by the main opposition Sam Rainsy Party (SRP) and the smaller opposition Human Rights Party. According to the SRP, the sales of vast swathes of Cambodia's national resources to foreigners, as well as a rise in foreign debt, forced the party to take action. While such boycott measures will actually expedite policy formation and execution, Cambodia's weak democratic credentials will continue to weigh on the country's political risk profile.

Cambodia's short-term political risk rating is 62.7.

ECONOMIC RISK

Ratings Downgrade

Standard & Poor's downgraded Cambodia's sovereign credit rating to 'B' from 'B+' in early November. The ratings agency pointed to an unstable political environment, low per capita incomes, and high levels of dollarisation as the key factors weighing on the country's external rating. It noted, however, that any improvements on the fiscal front could lead to future upgrades. While the ratings downgrade is a concern for the country's sovereign credentials, we believe that the economic fallout will be limited. Cambodia has no commercial external debt, and all funding needs are currently taken care of by concessionary lending.

Our short-term economic risk rating is 35.4.

BUSINESS ENVIRONMENT

Chinese Mining Interest

Chinese metal firm Guangxi Nonferrous Metal Group is planning to invest US$500mn in a steel plant and industrial zone in Cambodia over the next three years, according to the company's vice-chairman, Yang Daoxi. The firm has already invested US$30mn in exploring iron ore in Roveang district of Preah Vihear province in northern Cambodia. If Daoxi's plans come to fruition, the proposed levels of foreign direct investment would be equivalent to 4.5% of 2011 nominal. Such a sizeable amount could help ignite further interest in the country's nascent mining sector.

Cambodia's business environment score is 35.5.

ECONOMIC OUTLOOK

Growth Set To Stumble

BMI View: While latest activity data suggest a strong showing for the Cambodian economy in 2011, the flood-induced slowdown in Q411 will continue into 2012 as external conditions deteriorate. We forecast real GDP growth of 4.8% for 2012, below IMF (6.5%) and Asian Development Bank (6.5%) projections.

Latest data suggests that Cambodia is on course to clock strong economic expansion in 2011. Garment exports registered healthy average expansion of 36.3% y-o-y in the first nine months of the year. Tourist arrivals have remained on a firm upward trajectory, with growth hitting a 10-month high of 21.2% y-o-y in September. And construction approvals grew by a whopping 93.3% y-o-y to US$244mn in the first eight months of the year, bringing to an end seven consecutive quarters of year-on-year contraction. While still well below the Q109 peaks, projects such as the US$1.6bn satellite city on the Phnom Penh peninsula show that infrastructure investment has started to perk up.

Despite the strong year-to-date performance, we expect some softening of the Q411 numbers due to the impact of harsh flooding both domestically and in neighbouring Thailand. The final cost of flood damage is expected to be in the region of US$250mn, or 2.3% of 2010 nominal GDP, sufficient to take the shine off full-year growth. Furthermore, Thailand is a key arrival point for international tourists coming into Cambodia, and heavy flooding there is likely to hurt fourth quarter tourist numbers. On balance, therefore, we are pencilling in full-year real GDP growth of 6.3% in 2011, below the Asian Development Bank and IMF projections of 6.8% and 6.7% respectively.

Looking further ahead, we are likely to see some slippage in headline growth in 2012, as external conditions turn south. Over 80% of the country's garment exports are destined for the EU and US, and while Cambodia does typically export lower-end clothing (and could benefit from consumer retrenchment patterns), we would not expect current export momentum to be sustained. It is a similar story for tourism arrivals and expenditure, which is a mainstay of the local service industry and also more exposed to a sharp slowdown in Chinese demand (our core scenario). On balance, we believe real GDP growth will moderate to 4.8% in 2012, putting us well below the consensus of 6.5%.

DATA & FORECASTS

BMI View: Cambodia plans to spend US$200mn (2% of GDP) to rebuild the country's damaged infrastructure following the worst flooding in a decade, according to the finance minister. The government had allocated US$54mn from the 2011 budget to rehabilitation, with US$90mn earmarked for 2012. While reconstruction efforts should help cushion economic activity in 2012, we still expect headline GDP growth to fall to 4.8% from a projected 6.3% in 2011.

	2009	2010	Latest Period		2011f	2012f
Population, mn [4]	14.0	14.1	-	-	14.3	14.5
Nominal GDP, US$bn [5]	10.4	-	-	-	12.8	13.5
GDP per capita, US$ [5]	747	776	-	-	893	932
Real GDP growth, % chg y-o-y [5]	0.1	5.9	-	-	6.3	4.8
Fiscal revenue, KHRbn [1,5]	6,134.7	7,312.2	-	-	8,100.2	8,655.3
Fiscal expenditure, KHRbn [2,5]	8,827.6	9,500.1	-	-	10,251.5	11,152.0
Budget balance, % of GDP [2,5]	-6.3	-4.8	-	-	-4.1	-4.4
Consumer prices, % y-o-y, ave [3,6]	-0.4	4.0	6.7	Sep	5.5	4.2
Lending rate, %, eop [7]	15.6	15.9	-	-	15.2	15.0
Exchange rate KHR/US$, eop [8]	4,145.00	4,053.00	-	-	4,200.00	4,300.00
Goods imports, US$bn [5]	5.8	6.8	-	-	8.1	8.9
Goods exports, US$bn [5]	4.2	5.1	-	-	6.2	6.9
Balance of trade in goods, US$bn [5]	-1.6	-1.7	-	-	-1.9	-2.0
Current account, US$bn [5]	-0.9	-0.9	-	-	-1.0	-1.1
Current account, % of GDP [5]	-8.9	-	-	-	-8.0	-8.2
Foreign reserves ex gold, US$bn [9]	2.9	3.3	-	-	3.6	3.9
Import cover, months g&s [9]	5.9	5.8	-	-	5.3	5.2
Total external debt stock, US$mn [5]	4,364.0	4,887.7	-	-	5,278.7	5,701.0
Total external debt stock, % of GDP [5]	41.8	-	-	-	41.3	42.2

Notes: e BMI estimates. f BMI forecasts. 1 Central Government including grants; 2 Central Government; 3 Base Year = 2001; Sources: 4 World Bank/UN/BMI. 5 Asian Development Bank/BMI; 6 National Bank of Cambodia/BMI; 7 IMF; 8 BMI; 9 IMF/BMI.

ECONOMIC OUTLOOK

Power Sector Attractive

BMI View: Despite the global economic downturn, we find Laos's investment climate to be relatively attractive, especially for the hydropower and mining sectors. We expect foreign direct investment to remain strong over the medium to long term. That said, we believe a dependence on resource wealth is not a sustainable growth model and risks marginalising other industries within the economy.

Our long-term bullish view on Vietnam's and Thailand's growth prospects suggests that we should maintain a similar stance on Laos's hydropower sector. Laos consumes less electricity than it produces, and its neighbours persistently facing power shortages. With much of Vietnam's industry in its nascent stages and expected to grow resiliently over the longer term, we expect its demand for power to increase in lockstep with its economy. Half of the hydropower plants presently under construction have Thailand and Vietnam as key markets.

The recent surge in commodity prices has presented Laos's economy with a windfall this fiscal year. According to the Ministry of Planning and Investment, revenues from the mining sector surged 58% year-on-year in the first half of FY2010/11 (October-September), raking in revenues to the tune of almost US$900mn. Mineral and metal exports contributed more than 50% of total export value, with copper alone accounting for 27%. In addition, the sector provides a significant source of foreign exchange from the huge FDI it attracts. We also see the gradual influx of foreign mining companies as a constructive development for the overall mining industry given the spillover benefits that entail in the form of the sharing of technology and expertise.

While we are broadly optimistic of longer-term growth in the two sectors, we acknowledge that downside risks certainly exist. We highlight the fact that such strong FDI into just these two resources risks starving the economy's other industries of badly needed investment and ensuingly, growth opportunities. Over a longer term, should the government rely solely on resources and neglect the rest of the economy, the manifestation of the 'Dutch disease' would prove detrimental and derail economic growth. Moreover, subjecting the economy to the fortunes of just two sectors runs against the maxim of diversification. As much as the economy has reaped a great deal from the surge in commodity prices, its fortunes are likely to ebb should a sharp decline in prices transpire.

DATA & FORECASTS

BMI View: Laos' consumer price inflation (CPI) has been on a recent uptrend following a sharp reversal from a peak of 9.8% y-o-y in May as global commodity prices saw a considerable decline. Headline inflation in October came in at 6.7% y-o-y, up from 6.3% in August and 6.4% in September. We expect a sustained uptrend in inflation as the effect of the Thai floods filters through. We forecast inflation ending 2011 above 7% before easing and averaging 5.8% in 2012.

	2009	2010	Latest Period		2011	2012f
Population, mn [2]	6.1	6.2	-	-	6.3	6.4
Nominal GDP, US$bn [3]	5.6	6.6	-	-	7.8	9.1
Nominal GDP, LAKbn [3]	47,566.6	54,183.7	-	-	62,191.9	70,120.2
GDP per capita, US$ [3]	914	1,057	-	-	1,247	1,429
Real GDP growth, % chg y-o-y [3]	7.6	7.5	-	-	6.5	6.9
Budget balance, LAKbn [1,4]	-2,787.0	-2,515.8	-	-	-2,629.9	-2,737.3
Budget balance, % of GDP [1,4]	-5.9	-4.6	-	-	-4.2	-3.9
Consumer prices, % y-o-y, eop [5]	3.9	5.8	Oct	6.7	6.0	5.0
Exchange rate LAK/US$, eop [6]	8,493.40	8,057.00	Oct	8088.50	7,800.00	7,600.00
Goods imports, US$bn [3]	1.4	1.5	-	-	1.8	2.1
Goods exports, US$bn [3]	1.0	1.1	-	-	1.3	1.6
Balance of trade in goods, US$bn [7]	-0.4	-0.4	-	-	-0.5	-0.5
Current account, US$bn [3]	-0.1	-0.1	-	-	-0.1	-0.2
Current account, % of GDP [3]	-2.4	-1.1	-	-	-1.4	-1.7
Foreign reserves ex gold, US$bn [3]	0.7	0.8	-	-	0.9	1.1
Import cover, months g&s [3]	6.0	6.6	-	-	6.3	6.1
Total external debt stock, US$mn [8]	5,538.9	6,072.8	-	-	6,656.0	7,299.0
Total external debt stock, % of GDP [8]	99.2	92.6	-	-	84.9	80.2

Notes: e BMI estimates. f BMI forecasts. 1 Fiscal years ending in September, 2007= FY2006/2007; Sources: 2 World Bank/UN/BMI. 3 Asian Development Bank; 4 Asian Development Bank, National Statistics Office; 5 IMF; 6 IMF,BMI; 7 Bank of Lao, Asian Development Bank; 8 World Bank, BMI.

RISK SUMMARY

POLITICAL RISK

Murky Intentions Behind Chinese Investments

High level officials from Laos and China recently pledged to enhance cooperation. Laos stands to benefit considerably from closer ties with China, especially since the latter remains one of Laos' top foreign investors. That said, we remain cautious of China's extensions into the country. Anecdotal evidence has surfaced suggesting that some Chinese investments in Laos have been established as a front for money-laundering purposes while other investments have seen the benefits skewed towards the mainland investors and not toward the broader economy.

Laos' short-term political risk rating is 80.4.

ECONOMIC RISK

Aid Required For Growth

The Lao government is seeking between US$700mn to US$800mn on average in Official Development Assistance (ODA) between 2011 and 2015 to achieve a targeted annual economic growth rate of 8.0%. This amount far exceeds the US$2.4bn in ODA that Laos received between 2006 and 2010. While we do not foresee any impediment to Laos obtaining the required aid, we highlight that any future aid it receives will be contingent on whether the government directs the funds towards appropriate investments and its adherence to the requirements set out by development partners.

Laos' short-term economic risk ratings is 51.0.

BUSINESS ENVIRONMENT

New Business Park Opens

The Savan Industrial and Commercial Park in Savannahket province was recently opened by Deputy Prime Minister Somsavat Lengsavad. The park cost the Malaysian developer, Pacifica Streams Development Company, US$24mn to install the necessary infrastructure. The park aims to attract foreign investment into the East West Economic Corridor and has thus far seen 21 companies registered to operate within the park. Developments such as this bode well for Laos' business environment and should they be sustained over the longer-term, we can expect to see spillover effects into the broader economy.

Laos' business environment ratings is 26.4.

POLITICAL OUTLOOK

Five Political Risks To Watch

BMI View: Following a relatively quiet year, we expect to see political noise grow louder across emerging Asia in 2012, particularly as economic conditions deteriorate. In this article, we look at some low probability/high risk events that could threaten to erupt over the coming 12 months.

Against a backdrop of uprisings across much of the Middle East and North Africa, political noise has remained quiet in emerging Asia this year. Aside from the infrequent flare-up of inter-Korean tensions, isolated protests across China, and habitual security concerns in Pakistan, political risk, for the most part, has not been a major concern. Nevertheless, with economic growth set to fall in the coming quarters, and with important events on the regional calendar (not least a change of leadership in China), 2012 could see an uptick in regional political risk. In this article, we consider five potential flashpoints that could arise next year. While none are part of our core assumptions, they all remain major risk factors for investors operating in the region.

Chinese Unrest Reaches Tipping Point

It is disconcerting for investors to hear of increasing signs of violence aimed at Chinese developers due to falling property prices. Our core macro outlook calls for a double-digit decline in real estate valuations in 2012, as China's property boom unwinds, and the deflationary impact of falling land prices on local governments and the banking sector is likely to require some form of liquidity and/or bailout measures from Beijing. A major risk is that small and medium-sized enterprises will remain starved of financing to roll over their liabilities, which could lead to mounting solvency pressures and large-scale layoffs – ingredients for a surge in social disharmony. We forewarned of the likelihood of growing public unrest earlier this year, and latest evidence indicates a growing voice of discontent towards the authorities. In a worst-case scenario, Beijing could be forced into hardline action against protesters on the eve of the change in leadership (scheduled for late 2012) as well as take even greater control of the domestic economy – both of which would bode poorly for foreign investors.

Indian PM Singh Forced To Step Down

India's Congress-led government is firmly against the wall. A high-profile trial on the country's 2G telecoms scandal, which was estimated to have cost the government coffers up to US$39bn, has just kicked off, and there is a chance that current government ministers may find themselves in the firing line as the hearing unfolds. Meanwhile, after several unproductive sittings, foreign investors are looking at the current parliamentary session as a final chance for the government to champion its reform credentials. The initial signs are not encouraging, however, with protests marring the opening day's session. In a worst-case scenario, a lack of policy reform, coupled with an enduring economic slowdown and potential mud-slinging in the 2G saga, could force Prime Minister Manmohan Singh to step down in 2012. Given that Singh is seen as an important counter-balance to the Congress Party's populist leanings, such a scenario would be a major concern to foreign investors as India's current account and fiscal account deficits remain worryingly large.

Thaksin Return Re-Ignites Thai Unrest

The spectre of ex-prime minister Thaksin Shinawatra's possible return from exile continues to hang heavy over Thailand's political outlook. On November 16, reports surfaced that the Thai government was preparing a royal pardon for convicts in time for King Bhumibol Adulyadej's 84th birthday on December 5 in a move that would allegedly pave the way for Thaksin's homecoming. Angry protests have since forced the administration of Prime Minister Yingluck Shinawatra (Thaksin's sister) to back down and claim that the amnesty would only cover serving prisoners, but the issue is unlikely to lie dormant for long. From our standpoint, the ruling Puea Thai Party will eventually attempt to carry out its campaign promise of seeking amnesty for the ex-premier. Given that business leaders are already disgruntled by the government's perceived mishandling of the recent flooding, and by plans to introduce minimum wage legislation, the return of Thaksin could be sufficient to re-ignite mass protests, as 'Yellow Shirt' demonstrators take to the streets. This is a major risk as we head into 2012, in our view, especially as the Thai economy continues to stumble.

Regime Collapse In North Korea

South Korea's Minister of Unification Yu Woo-ik hit the headlines in November by claiming that a reunification with North Korea is drawing nearer. While the minister failed to elaborate further, political upheaval across the MENA region and rumours of North Korean leader Kim Jong Il's poor health have certainly put Pyongyang back in the spotlight. We recently evaluated various scenarios for Kim Jong Il's succession (*see our online service, September 30 2011, 'Succession Scenarios Assessed'*). In a worst-case scenario, in which North Korean economic conditions continue to deteriorate and a hard landing in China sees Beijing focus more on domestic instability, we could well see a swift collapse of the Pyongyang regime. Whether reunification would occur, as suggested by Seoul, remains a moot point. Given that the North's military continues to dominate the political spectrum, we believe that a coup and/or civil war would be the most likely course of action in our most bearish case.

Sanctions Eased In Myanmar

In Myanmar, we are finally starting to see concrete signs of political reform, which could open the door to the reduction, or even removal, of EU and US economic sanctions in 2012. While we have hitherto remained wary of false dawns in the country's political landscape, the Union Solidarity and Development Party government has recently announced a number of concessions that point to a softening in policy. As we noted in October (see 'A Myanmar Spring?', October 20), the decisions last month to release 6,300 prisoners and to halt a controversial Chinese dam project were encouraging signs. Furthermore, the recent announcement that the opposition National League for Democracy will rejoin frontline politics – and that party leader Aung San Suu Kyi will compete for the first time in upcoming by-elections – is a major step in the right direction. In a sign of possible rapprochement, US Secretary of State Hillary Clinton is scheduled to visit Myanmar's leadership in early December, which could set the wheels in motion for an easing of sanctions next year.

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