

### OVERVIEW

The **weakness of the US economic recovery** was further underscored by a sharp decline in **consumer confidence** in June. The economy shed more jobs as weak private sector hiring failed to make up for the loss of thousands of temporary government jobs. Also, retail sales including autos, appliances and other big-ticket items, slowed over the past two months and manufacturing activity weakened in June. The number of new houses sold also fell for the third consecutive month following the withdrawal of government incentive programs. Meanwhile, inflation fell for a fifth consecutive month and the Federal Reserve on June 23<sup>rd</sup> kept interest rates unchanged to reflect the still weak recovery and the lower inflationary trend.

Separately, investors have grown worried that the risk of default by certain US local governments is increasing. There are signs that some municipalities face difficulties in curbing pension and budget deficits not unlike the situation confronting some Euro-zone countries. The yields of some infrastructure municipal bonds have risen relative to US Treasury bonds because of fears that cash-strapped local governments will struggle to pay these loans. Parts of **California** as well as towns and cities in **Illinois, Michigan** and **New York** are seen as the most vulnerable. There are growing expectations that under-funded pension systems will likely become a long-term problem for a number of US municipalities. There is the possibility of municipalities using bankruptcy for relief from pension obligations.

### EURO-ZONE

In **Ireland**, GDP grew by 2.7% during the first quarter. This was the first report of growth in the Irish economy for more than two years. By taking assertive steps to deal with the most potent sources of vulnerability in the economy, Irish policymakers have gained significant credibility. Measures to stabilize the banking sector and achieve substantial fiscal consolidation have demonstrated the resolve of the authorities to alleviate short-term risks while beginning to tackle major long-term challenges. The IMF recently stated that Ireland is likely to emerge from the recent economic contraction into a period of relatively modest growth potential (3.5% GDP), but with high unemployment (at around 9%), for the next few years.

Meanwhile, for the first time in months, investors started buying **Spanish** debt during the final week of June. This may indicate rising hopes that the worst of the Euro-zone bond crisis may now be over. Signs of recovery in the Greek and Portuguese bond markets and strengthening of the euro against the dollar further support this tentative optimism. An astonishing rebound in **Germany's** industrial fortunes is countering gloom about growth prospects in continental Europe. Overall the Euro-zone economy is expected to expand by 1.5% this year, with Germany at 2.3% being the fastest growing of the major European countries. Still, **Greece** is now regarded as the second most risky sovereign borrower in the world with credit markets indicating that it is more likely than not to default on its debts.



## THAILAND

A sense of relative normalcy has returned to Bangkok following a violent and chaotic two-month period of anti-government protests. However, this does not mean that the cause of the crisis has been resolved. The red-shirted protest movement (United Front for Democracy Against Dictatorship (UDD)), did not succeed in bringing down the government and forcing early parliamentary elections. However, the government did not emerge unscathed as its use of deadly force to end the protest has damaged its credibility. While the Prime Minister has issued a national reconciliation plan, it has been met with skepticism as the crisis has left the country split down the middle.

The widespread political turmoil caused year-on-year industrial growth to slow to 17.2%, down from 21.8% in May. The forecast is that Thailand will continue to under-perform as the political crisis will undermine investor and consumer confidence.

The central bank's business confidence index dropped to a nine-month low of 46, indicating that confidence has worsened. Although the decline in both consumer and business confidence has negative implications for all sectors of the economy, the tourism industry has borne the brunt of the initial fallout from the political unrest. Growth in total visitor arrivals was down sharply.

Even manufacturing output has not been immune. Operations in many industrial zones around the country continued mostly at a normal pace over the past few months, with utilities, transport networks and other parts of the logistics chain unaffected by the turmoil in the capital. However, on a seasonally adjusted basis, manufacturing output dropped by 2% during each month of the crisis.

There are varying estimates of the harm caused to the economy during the anti-government protests, in terms of both physical damage and foregone opportunities for businesses that were directly affected. The government has estimated the eventual cost of the unrest at \$4.4 billion, or around 1.5% of annual GDP and that it will need around \$4 billion to rehabilitate the economy. It is focusing its policy efforts on providing support to business and offering incentives to tourists and foreign investors. These include changes to the tax code to persuade foreign companies to locate their regional operating headquarters in Thailand. New regional bases will enjoy a 15-year exemption from corporate income tax and will pay only 10% tax on their total net profit. The government is also extending tax breaks to foreign employees of foreign companies locating in Thailand over an eight-year period. These privileges will take effect on June 1, 2010.

The currency, the baht has weakened slightly against the dollar in recent months, but nominal and real effective exchange rates have continued to appreciate, suggesting that economy's strong underlying fundamentals are offsetting negative sentiment arising from the political turmoil affecting the country. The Bank of Thailand (the central bank) which operates a managed float of the baht, will intervene in the currency market to prevent excessive volatility owing to the unstable domestic situation.



**THAILAND** (continued)

Thailand has maintained its budget deficit at manageable levels in relation to GDP. At a time when key industrial countries have double-digit debt/GDP ratios, Thailand's budget deficit is expected to narrow to 3.6% of GDP in 2010 from 4.4% in 2009. However, the country's debt burden remains large. The public debt is expected to rise to 54% of GDP over the next few years, up from 48% in 2009. The current account will remain in the black in 2010-11, posting a surplus equivalent to 6% of GDP. This is a fall from the 7.7% surplus in 2009, when imports contracted even more sharply than exports. Thailand's exporters are enjoying a healthy rebound in revenue owing to the recovery in Asia and in the global economy. Imports are projected to pick-up as well as growth in consumption and investment resumes. The increase in Thai imports is expected to be particularly strong this year, reflecting the steep drop recorded last year. Tourism receipts will remain fairly weak in 2010 owing to the severe impact that the recent political violence in Bangkok will have on that sector.

**CHINA**

The Chinese authorities adjusted the currency exchange rate slightly, allowing it to trade more freely against a basket of currencies. This ends the Chinese yuan peg with the dollar, which has created tension between China's policymakers and the US and other trading partners. While the Chinese authorities did not agree to a one-off revaluation of the yuan, which is what most critics wanted, the move at least addressed concerns that China was not committed to re-balancing its economy. By allowing a more flexible yuan, China stands a better chance of disarming its critics, who believe that it has been unfairly subsidizing its exports with a cheap currency. The move also gives China more tools with which to cool its economy and tame inflation. A stronger yuan would cut the cost of imported goods and by abandoning the fixed tie with the dollar China has liberated its interest rate policy. Meanwhile, China's huge current account surplus was cut by a third as a share of GDP in 2009, and it seems to be shrinking further this year.

While this recent change in direction on the currency peg won't work immediate wonders for China's trading partners, the risk of a currency dispute leading to a trade war is now remote.

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