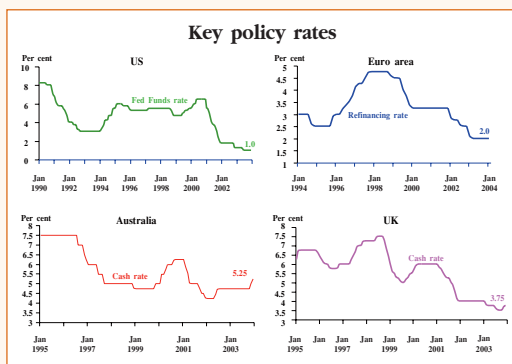
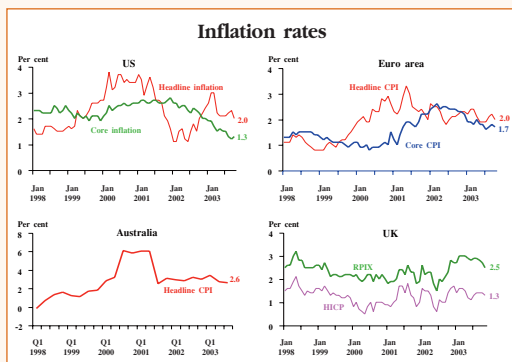


## Global Interest Rate Trend

The MPC has been closely monitoring the direction of the global interest rate trend to assess its impact on the Thai economy in future periods. During 2003 Q4, signs of an upward interest rate cycle began to emerge. The Bank of England raised its policy rate by 25 basis points to 3.75 per cent (6 November 2003). Meanwhile, the Reserve Bank of Australia (RBA) raised its policy rate by 25 basis points for 2 consecutive months (3 November and 4 December 2003) to 5.25 per cent. For most industrialized countries, its interest rate cycles have reached the trough. Looking forward, interest rates abroad should thus trend upwards, following improvements in global economic conditions. The rising interest rate path may affect capital flows, which in turn could lead to exchange rate volatility.



Source: Bloomberg



Source: Bloomberg

raise the cash rate for 2 consecutive months to 5.25 per cent to dampen credit growth and reduce price pressure.

For the Bank of England (BOE), main reasons behind the hike in the policy rate includes the gradual pick up in underlying inflationary pressures and rapid credit growth, especially housing credit. The BOE's inflation target, the Retail Prices Index Excluding Mortgage Interest Payments (RPIX), stood at 2.7 per cent in October 2003, above the 2.5 per cent target.

To determine the timing and magnitude of the interest rate hike, central banks need to carefully consider the pace of economic growth and the risk of rising inflation expectation. Economic indicators include capacity utilization, private investment trends, liquidity, credit growth, exchange rates, and asset prices.

In the case of Australia, the inflation rate is currently close to the target mid-point. One of the main reasons for the decline in inflation rate during the past 2 years is the pass through effect from exchange rate appreciation. However, once these effects diminish, inflation is expected to rise from the surge in domestic demand, the strengthening of labour market conditions, higher asset prices and price pressures from the non-tradable sector. In addition, credit growth accelerated to 14 per cent (a 20 per cent credit increase to the household sector), surpassing the economic growth rate. The RBA's Monetary Policy Board thus decided to

The BOE recently changed its target from the RPIX to the Harmonized Index of Consumer Prices (HCPI) at 2 per cent, allowing the target to move within the +/- 1 per cent range. Although the HCPI remained within its target range, the MPC may consider raising its policy rate due to higher inflation expectations. The BOE, however, may be less aggressive as the effect of the exchange rate appreciation is expected to hold down inflationary pressures.

### **Interest rate trends in industrial and regional economies**

The Fed funds rate is one of the key assumptions that the MPC uses in assessing economic conditions and forecasting inflation for the next 8 quarters. Viewing recent economic developments in the US, the MPC chose the assumption that the Fed funds rate will remain at 1 per cent until mid 2004, with a series of interest rate hikes from the second half of 2004 onwards. Some analysts, however, expect the Fed to keep the rates unchanged for at least another year or longer due to the low inflation rate. Core inflation stood at 1.1 per cent in November 2003. The low inflation rate was partly attributable to the remarkable increase in labour productivity, resulting in higher potential output and thus reducing the cost of production, which exerted downward pressure on prices. In addition, the slow pace of recovery in the labour market remains a risk to the sustainable economic recovery. In those circumstances, the Fed is likely to maintain an accommodative monetary policy stance for a considerable period to support economic growth and to prevent an undesirable fall in inflation.

The European Central Bank's (ECB) interest rate policy is expected to remain at 2 per cent for the periods ahead due to the slow pace of economic recovery. In addition, the recent appreciation of the euro is likely to put downward pressure on price. The inflation rate remains close to the 2 per cent target. However, should the euro continue to appreciate further and hamper economic recovery, there is room for a policy rate cut to offset the effects of the strong euro.

In the case of Japan, an accommodative monetary stance is expected to continue, owing to the appreciation of the yen. The interest rate trend of Asian economies is expected to remain low. Strong economic growth experienced in these countries, however, will not put pressure on inflation. Inflation in most Asian economies has been trending downwards since the beginning of the year, except China. The average rate of inflation in China, Korea and Taiwan was around 1-2 per cent in 2003. Hong Kong has been experiencing persistent deflation for 5 years, while inflation in Singapore and Malaysia remained low, standing below 2 per cent.

Against the background of accelerating global economic recovery, setting the direction of monetary policy in the periods ahead will be a challenging task. It is widely acknowledged that it will take some time for the monetary policy to affect inflation. Thus, the success of monetary policy operations will depend on the ability of the MPC to anticipate events accurately and take into consideration shocks to the economy, which could cause upward pressure on price. Consequently, the MPC considers it imperative to determine the appropriate timing for monetary policy adjustments to support sustainable economic growth, as well as preparing the market to adjust in advance.