Global interest rate outlook in 2006

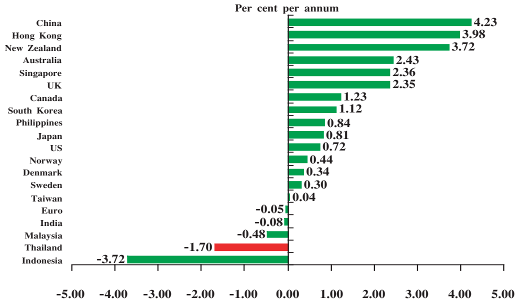
Interest rate trends in major foreign economies are one of the crucial factors that can have a significant impact on the Thai economy through capital flows and exchange rate movements. When interest rates in some countries started an upward trend in 2003 Q4, the Monetary Policy Committee (MPC) studied this issue and presented an analysis in the January 2004 issue of the *Inflation Report*.

Table 1 Policy rates of selected countries

Country	Official interest rate	Current (% p.a.)	Latest change	Change from Jan 04 (bp)
United States	Federal Funds Rate	4.25	13 Dec 05 (+25bp)	325
Canada	Overnight Funding Rate	3.25	6 Dec 05 (+25bp)	125
Euro	Refinancing Rate	2.25	1 Dec 05 (+25bp)	25
United Kingdom	Repo Rate	4.50	4 Aug 05 (-25bp)	0
Japan	Overnight Call Rate	0.00	19 Mar 01 (-15bp)	0
Taiwan	Official Discount Rate	2.25	22 Dec 05 (+12.5bp)	87
Thailand	14-day Repo Rate	4.25	18 Jan 06 (+25bp)	300
South Korea	Overnight Call Rate	3.75	8 Dec 05 (+25bp)	0
New Zealand	Cash Rate	7.25	8 Dec 05 (+25bp)	150
Indonesia	BI Rate	12.75	6 Dec 05 (+50bp)	451
Malaysia	O/N Interbank Rate	3.00	1 Dec 05 (+30bp)	30
India	Reverse Repo Rate	5.25	25 Oct 05 (+25bp)	75
Philippines	Reverse Repo Rate	7.50	20 Oct 05 (+25bp)	75
Australia	Cash Rate	5.50	2 Mar 05 (+25bp)	25

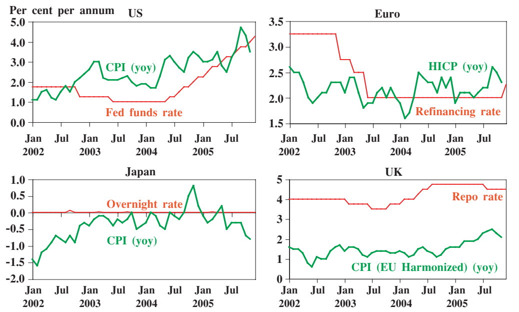
Source: Bloomberg and Bank of Thailand, As of January 2006

Chart 1 Real policy rates of selected countries



Source: Bloomberg and Bank of Thailand, As of 16 January 2006

Chart 2 Monetary policy rates and headline inflation



Source: Bloomberg and CEIC

Most major economies are expected to continue tightening monetary policy in 2006 as a result of (1) **widening interest rate differentials,** as the US started its tightening cycle before other countries and has raised the policy rate steadily, prompting others to follow suit to stabilise capital movements; (2) **inflationary pressures,** given that oil prices are expected to remain high throughout 2006; and (3) **buoyant world economic growth,** which leads central banks to adjust their policy rates upwards in order to maintain price and exchange rate stability that is supportive of sustainable economic growth. Nevertheless, real policy rates in many countries remain low and conducive to economic growth.

Monetary policy of major industrialised economies in 2006

Varying domestic economic conditions give rise to different paces of monetary tightening. While the US Federal Reserve (Fed) is expected to end its tightening policy some time in 2006, the European Central Bank (ECB) is likely to raise its policy rate (refinancing rate) further depending on the economic outlook, which is expected to be favourable. The Bank of Japan (BoJ) indicates that it may exit from the quantitative easing policy if deflation eventually ends. On the other hand, with inflation remaining low, the Bank of England (BoE) may cut its policy rate to support a softening economy.

The **Fed,** having embarked on the tightening cycle since June 2004, is expected to end by the first half of 2006. After 13 consecutive rate hikes, the fed funds rate was raised to 4.25 per cent per annum at the latest FOMC meeting on 13 December 2005. In the released FOMC statement, the word "accommodative" was omitted after being included in previous statements, leading the market to expect that the rate hike will be ending shortly. This is because

US economic growth is expected to soften in 2006, albeit remaining above its long-term average, as the tightening process has led to a slowdown in domestic consumption and the real estate sector. Meanwhile, inflationary pressures have been contained, as oil prices level off and the pass-through of higher energy costs to core inflation remains subdued. Consequently, most analysts expect 1-3 additional rate hikes in 2006, which will leave the fed funds rate at 4.50 - 5.00 per cent per annum.

The **ECB** may further increase its policy rate, though not as consecutively as the Fed's increase, depending on the outlook of price stability and economic growth. In its meeting on 1 December 2005, the ECB raised its refinancing rate for the first time in 2 years by 25 basis points to 2.25 per cent per annum owing to inflationary pressures. The Harmonised Index of Consumer Prices (HICP) inflation rate rose to 2.3 per cent year-on-year in November 2005, which was above the ECB's long-term target of 2 per cent. Moreover, several economic indicators point towards a euro-area recovery in the second half of 2005 which is likely to continue into 2006. With output starting to recover, the ECB may increase the refinancing rate so that it will be consistent with economic conditions, although gradual adjustments in the policy rate are expected as the economy is still fragile.

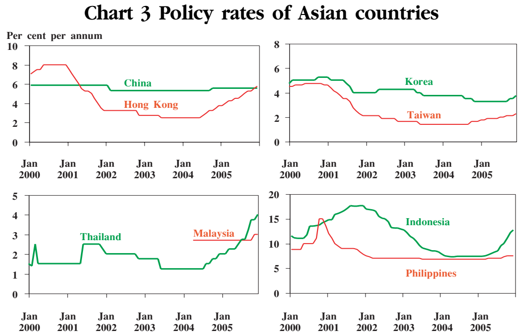
The **BoE** is likely to lower its policy rate further after the first rate cut of 50 basis points to 4.50 per cent per annum on 4 August 2005. This follows from a marked slowdown in growth while inflation has been falling. Nevertheless, future interest rate adjustments will depend crucially on the strength of the economy.

The **BoJ** may end the quantitative easing policy that has been implemented for over 4 years, if deflation is over. The central bank indicates that, once core inflation stays positive and the economy continues to expand, it will stop supplying liquidity to boost aggregate demand. At present the economy is in the early stage of recovery, driven by domestic consumption and investment and by a rebound of exports in the second half of 2005. The Japanese economy thus appears poised to continue expanding.

Asian economies

With inflationary pressures from higher oil prices, higher-than-expected GDP growth rates, and widening interest rate differentials between Asian and industrialised countries, most Asian countries have begun their tightening cycles to maintain economic stability, albeit at different paces. This upward trend in interest rates is likely to continue in 2006. Bank Indonesia has increased its policy rate at a rapid pace as domestic inflation reached double digits in the second half of 2005. Bank Negara Malaysia also raised its policy rate for the first time in 2 years on 1 December 2005 due to strong economic growth and rising inflation. Although Bangko Sentral ng Pilippinas recently maintained its policy rate, rates hikes are expected in 2006 if inflationary pressures build up.

Chart 3 Policy rates of Asian countries



Source: Bloomberg and Official Web Sites