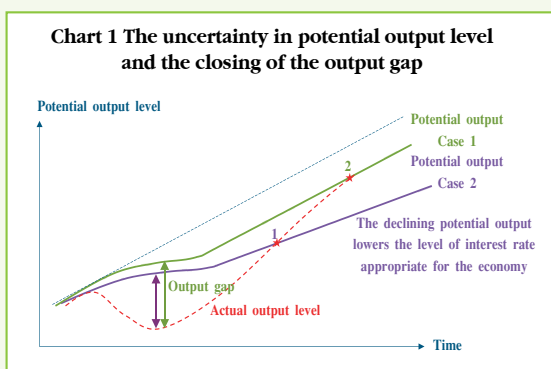


The uncertainty in potential output and the implication on monetary policy after crisis

The sharp plunge in private investment especially in the export sector as a result of the global financial crisis had not only caused a deep fall in Thailand's actual output (GDP), but had also led to a deterioration of potential output via a slowdown in the capital stock accumulation. The unobserved component model (October 2008 *Inflation Report*) indicated that the level of the country's potential output had declined by 1.0-1.5 per cent from its pre-crisis trend, reflecting deterioration in the country's ability to produce without increasing price pressure. The extent of the slowdown in potential output would have important implications for monetary policy going forward, especially once the economic recovery was firmly established. The dynamics of potential output adjustments would depend mostly upon the size of the initial impact from the financial crisis together with the degree to which private investment and hence capital accumulation could be bolstered. As a consequence, the uncertainty of the speed of economic recovery and the associated repercussion for capital accumulation would complicate the assessment of the level of potential output subsequently. In particular, potential output may either continue to expand at the pre-crisis rate (Case 1) or grow at a permanently lower rate (Case 2).



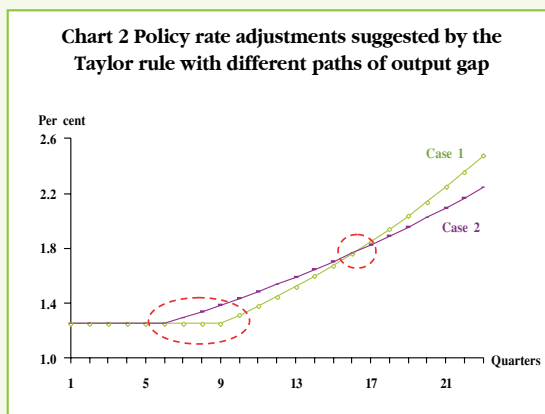
In addition, certain determinants of potential output such as the level of capital stock, labour input and factor productivity are not directly observable in real time, which adds to the limitations of accurately measuring the potential output. Coupled with the uncertainty in the path of economic recovery, the assessment of potential output and hence the output gap

presents a major challenge to monetary policymakers going forward.

In this light, the uncertain adjustment path of potential output as well as the measurement problems will have implications for the closure of the output gap, and hence the direction and timing of monetary policy adjustments in fostering an economic recovery going forward. The closing of the output gap depends on the speed of economic recovery and the adjustment path of potential output which is uncertain. For example, the current condition which is likely characterized by a negative output gap indicates that short-run support from monetary and fiscal policy continues to be essential to the economy. However, as output approaches the potential level and inflationary pressure starts to build, accommodative policy

may then need to be removed. Under such circumstance, three possible scenarios for the closing of the output gap are: (1) the actual output increases from the policy stimulus, (2) the potential output declines and approaches the current level of actual output, or (3) actual output and potential output converge.

The underlying reason for the closing of output gap, as far as the implication for monetary policy conduct is concerned, is not as important as the timing of the closing which has direct bearing on the appropriate monetary policy required. In this instance, the Taylor rule may serve as a reference for the appropriate policy interest rate in response to output gap and inflation deviation from the target level. Fixing the path of actual output, the Taylor rule suggests that the case of declining potential output (Case 2) should induce the central bank to raise policy interest rate earlier than in the case where the potential output returns to grow at the pre-crisis rate (Case 1). The earlier policy rate hike in Case 2 designed to contain the inflationary



pressure may however jeopardize the fragile prospect of an economic recovery, especially in the event that downside risks remain significant. Nevertheless, Case 2 will also result in a lower rate of return or borrowing cost. In other words, despite the sooner policy rate hike, the adjustment of monetary policy in Case 2 would take place at a slower pace and smaller in magnitude relative to Case 1.

Consequently, uncertainty in potential output level determination going forward will result in the uncertainty in output gap closure that will be a major challenge to monetary policy-making, especially when the immediate objective is to engineer a sustained economic recovery. The MPC had deemed that the path of monetary policy adjustment in the periods ahead would need to be carefully assessed and subsequent action should be conducted in a cautious manner to avoid interrupting the sustainability of economic recovery.