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Monetary Policy Report, June 2020

The Bank of Thailand (BOT) released the June 2020 issue of the *Monetary Policy Report*. The *Report*, published quarterly, is aimed at enhancing public understanding of the Monetary Policy Committee (MPC)'s policy stance and its assessment of Thailand's economic outlook. Details are summarized as follows.

Monetary Policy Conduct in the Second Quarter of 2020

At the meeting on May 20, 2020, the Monetary Policy Committee voted 4 to 3 to cut the policy rate by 0.25 percentage point from 0.75 to 0.50 percent. Three members voted to maintain the policy rate at 0.75 percent at this meeting. The Committee viewed that the Thai economy would experience a larger contraction in 2020 than previously assessed due to a more-severe-than-expected impact of the COVID-19 outbreak and the containment measures implemented by governments in many countries including Thailand which led to disruptions of global economic activities. Moreover, the impacts of the economic contraction on employment and financial system vulnerability would be more pronounced. For this reason, most members viewed that additional monetary policy accommodation was necessary to provide an effective and timely support to the real economy. However, three members deemed it appropriate to assess the effectiveness of the previously implemented financial and credit measures. **On June 24, 2020, the Committee voted unanimously to maintain the policy rate at 0.50 percent.** At this meeting, the Committee assessed that the Thai economy would contract in 2020 more than the previous assessment, as the impact of the COVID-19 outbreak turned out more severe than expected. However, a gradual recovery was expected in the second half of 2020, when activities should begin to rebound in countries that could effectively contain the outbreak, including Thailand. The Committee viewed that extra accommodative monetary policy since the beginning of the year as well as the fiscal, financial, and credit measures additionally announced helped alleviate adverse impacts and would support the economic recovery after the pandemic subsided.

Looking ahead, as the environment facing the Thai economy would remain highly uncertain, the Committee would thus stand ready to use additional appropriate monetary policy tools if necessary. Moreover, at the current juncture, the Committee deemed it important to (1) efficiently distribute liquidity in the financial system, which remained ample at the macroeconomic level, to businesses and households affected by the pandemic, (2) accelerate debt restructuring for borrowers while debt holidays and debt reduction measures were still in place, and (3) introduce supply-side policies to support changing economic structure in order to ensure a strong recovery in the post-COVID environment. These included, such as, establishing mechanism to manage excess production capacity, enhancing high-potential industries, accelerating infrastructure investments, facilitating upskill of labor, and accelerating reform of government regulations that remained obstacles.

<u>Assessment of the Economic and Financial Outlook as the Basis for Policy Formulation</u>

1. Global Economy

The global economy would severely contract as governments in many countries implemented containment measures, causing disruptions to global economic activities. Consequently, this severely affected manufacturing, employment, private consumption, and private investment, as well as merchandise exports, which contracted across major advanced economies and Thailand's trading partners in Asia. Thus, most countries especially major advanced economies were expected to enter a recession in 2020. **Given such development, the Committee revised down economic growth projections for Thailand's trading partners to a 4.6 percent contraction in 2020, followed by a 4.2 percent expansion in 2021. Also, there remained risks that trading partner economies would underperform the baseline projection.** These risks included a more severe and prolonged outbreak than previously assessed due to an emergence of the second wave of the outbreak, greater vulnerabilities in the global financial system owing to increased risks of defaults or credit rating downgrades among corporates or governments in some countries, re-intensifying trade tensions between the U.S. and China, and geopolitical risks such as tensions between Mainland China and Hong Kong. On the other hand, there were also possibilities that trading partners' economic growth would outperform the baseline projection if the pandemic ended sooner than expected or government stimulus measures worldwide would turn out to be more effective than expected.

Governments in various countries worldwide implemented additional fiscal and monetary measures to alleviate the economic impact of the COVID-19 outbreak. Governments introduced series of relief measures aimed particularly at SMEs, households, and employment. At the same time, central banks in major advanced economies implemented unconventional measures in addition to maintaining ultra-low policy interest rates, while many regional central banks eased monetary policy further. Also, a number of central banks introduced measures to support stability of the financial markets to ensure sufficient liquidity in their respective markets.

2. Financial Conditions and Financial Stability

Overall financial conditions in Thailand became more accommodative as reflected by the real policy interest rate, computed using the one-year ahead inflation expectations, that declined and remained low compared with those in other emerging markets. In addition, interest rates in Thailand's financial markets declined. Short-term government bond yields fell by more than long-term yields, causing the government bond yield curve to steepen. Corporate credit spreads stabilized at a high level after having risen at the beginning of the second quarter of 2020, as investors were concerned about the profitability outlook of some businesses. Meanwhile, commercial bank lending rates declined substantially in line with the policy rate and the reduction in the Financial Institutions Development Fund (FIDF) contribution. Corporate financing accelerated in line with the need for liquidity buffer among businesses, and also as a result of the government's soft loan programs. With regard to exchange rates, the baht against the U.S. dollar and the effective exchange rate appreciated throughout the second quarter, thanks to Thailand's success in containing the spread of the virus. Adding to the strength of the baht were sales of the U.S. dollars by domestic players, particularly those related to the sales of gold when pandemic uncertainties drove up the gold price. Nevertheless, the Committee expressed concerns over the strength of the baht and its potential impacts on economic recovery. The Committee would thus closely monitor developments in the foreign exchange markets in order to assess the necessity of implementing additional appropriate measures.

The Thai financial system became more vulnerable due to this year's contraction of the economic outlook in light of the COVID-19 situation, although stability of financial institutions, the external sector, and the fiscal sector remained robust. A larger-than-expected contraction of the global economy could result in (1) sharp corrections in asset prices in global financial markets, (2) defaults by businesses and households in many countries including Thailand, and (3) corporate bonds being downgraded to non-investment grade.

3. Economic and Inflation Outlook

The Thai economy would contract by 8.1 percent in 2020, more than previously assessed in the previous *Monetary Policy Report*. Such severe contraction would be observed across almost all economic growth components, except public expenditure. This was due to a more-severe-than-expected COVID-19 pandemic and the containment measures implemented by governments in many countries including Thailand. This led to temporary disruptions of global economic activities especially in the second quarter of 2020. Thailand's tourism and merchandise exports were thus projected to markedly contract, which would weigh on private consumption as a result of weakening income and employment. A fall in domestic and external demand would also lead to a sharp contraction in private investment. However, public expenditure would play an important role in supporting the economic recovery in the period ahead. The support would come from the reallocation of budget structure for a faster disbursement to remedy and restore the economy, as well as an additional liquidity support from the third phase of government relief measures to alleviate the impact of COVID-19. **Nevertheless, the Thai economy was expected to bottom out in the second quarter of this year and would gradually recover from the third quarter onward,** following the relaxation of containment measures in many countries including Thailand. Merchandise exports, tourism, and domestic demand would therefore exhibit a smaller contraction. **In 2021, the Thai economy was projected to expand at 5.0 percent, higher than previously assessed.** This was partly due to the lower base in 2020, and as government was expected to launch additional employment stimulus package and large-scale investment projects. However, economic activities in Thailand would remain substantially below its potential level.

Additional assumptions underlying the economic projection included, first, there would be no severe second-wave of the COVID-19 outbreak in Thailand. This would allow for the gradual re-opening of the country under the travel bubble scheme, which would be done through partnerships between COVID-19-free countries, permitting travelling into targeted locations in each countries starting from the second half of 2020. Second, there would be a widespread availability of COVID-19 vaccines from the fourth quarter of 2021 onward.

The value of Thai merchandise exports in 2020 would experience a sharper decline than previously assessed, due mainly to contraction in volume. This was in line with the outlook of trading partner economies and global trade volume, as well as supply chain disruptions in some businesses. Meanwhile, prices of merchandise exports were projected to decline, mainly owing to prices of goods that were sensitive to movements in crude oil prices. Nevertheless, the gradual relaxation of containment measures in many countries would support the gradual recovery of merchandise exports from the third quarter of 2020 onward. In 2021, the value of merchandise exports was expected to expand, both in terms of volume in response to the recovery of global economy and global trade, and in terms of price in line with the outlook of global crude oil prices. However, the value of merchandise exports would be below the pre-pandemic level, as external demand had yet to fully recover. In addition, changing patterns of business operations worldwide under the new way of life in the post-COVID environment would limit the potential of certain industries to fully recover.

The tourism sector was projected to recover more slowly than in the previous assessment, as the outbreak in other countries would be more prolonged and widespread than previously expected. The Thai government was expected to maintain its travel restrictions on inbound foreign tourists for an extended period and would begin to gradually re-open the country for foreign tourists from certain countries under the travel bubble scheme in the second half of 2020.

The current account balance was projected to register a surplus of 15.5 and 20.2 billion U.S. dollars in 2020 and 2021, respectively. The current account balance in 2020 was revised down due to a larger deficit in the services balance, mainly as a result of a marked decline in tourism receipts. For 2021, the current account balance was projected to increase from the previous year, owing to gradual improvements in trade balance and tourism receipts.

Public expenditure would play an important role in shoring up the economy in 2020 and supporting the recovery in the period ahead. The government was expected to accelerate disbursement of the fiscal year 2020 budget during the rest of the year, as well as reallocate the budget structure for a faster disbursement to remedy and restore the economy thanks to the Budget Expenditure Transfer Act, B.E. 2563 (A.D. 2020) and the revision of the fiscal year 2021 budget structure. There would also be an additional liquidity support from the third phase of government relief measures to alleviate the impact of COVID-19. In addition, the government would introduce further measures to help those affected by the outbreak, which would partly help sustain business operations and employment. Nevertheless, investment spending by state-owned enterprises was projected to expand, which would be key mechanism to support the economy going forward.

Private consumption was expected to contract in 2020 more than the previous assessment, particularly in the second quarter. This was due to the containment measures, as well as a marked decline in non-farm income and weakening consumer confidence. However, the gradual relaxation of containment measures would lead to a gradual improvement in economic activities in the period ahead. Nevertheless, private consumption was expected to grow at a level below the pre-pandemic level throughout the forecast horizon. This was because households were expected to be cautious in spending given high uncertainties surrounding the COVID-19 situation going forward. Furthermore, households' financial positions would be more vulnerable given falling income and elevated debt levels.

Private investment was expected to contract in 2020 more than the previous assessment. This was on account of contractions in both domestic and external demand, as well as high levels of excess production capacity, which caused most businesses to postpone their investment plans. However, the government's infrastructure investment projects were underway, particularly the public-private partnership (PPP) projects both within and outside the Eastern Economic Corridor (EEC). As for 2021, some investment projects would likely continue, particularly large-scale infrastructure investment and infrastructure investment to support the digital economy.

Going forward, the Thai economy would continue to face high uncertainties. Risks to the economic projection tilted downward and depended largely on the impact of COVID-19. The possibilities that the Thai economy would underperform the baseline projection would be due to the following factors. First, the global economy could recover more slowly than expected or enter a severe recession, which would lead to a larger-than-expected impact on Thai merchandise exports. Second, default risks of businesses and households could increase. Third, the recovery of the tourism sector could be slower than expected. Forth, Thailand could experience the second wave of the COVID-19 outbreak, triggering another round of lockdown measures. However, **there were possibilities that the Thai economy would outperform the baseline projection** due to (1) better-than-expected impacts of additional government's stimulus measures to shore up domestic consumption and investment, and measures to assist borrowers, (2) public infrastructure investment and PPP projects which could incentivize the private sector to invest more than expected, and (3) more relocations of production base to Thailand thanks to the success in containing the spread of the virus.

Headline inflation in 2020 would be more negative than previously assessed, mainly due to supply-side factors. This was particularly because of sharply declined energy prices in line with global crude oil prices, which was owing to decreasing demand following disruptions of global economic activities and high levels of excess production capacity. Moreover, a fall in headline inflation was partly due to government measures to reduce electrical and water bills. Meanwhile, **core inflation would remain low** in line with muted demand-pull inflationary pressures. **Looking ahead, headline inflation would gradually rise toward the target** mainly in tandem with gradually rising crude oil prices. However, core inflation would remain subdued in line with Thailand's gradual economic recovery outlook. **The Committee thus projected headline inflation to be negative at 1.7 percent in 2020 and turn positive at 0.9 percent in 2021. Core inflation was projected to be zero and 0.1 percent in 2020 and 2021, respectively.** Going forward, the inflation outlook would remain highly uncertain, as the COVID-19 pandemic had altered global economic structure, which resulted in large excess capacity in several industries. In addition, trade protectionism and geopolitical risks could lead to deglobalization, which would eventually result in a significant impact on global supply chains and prices of goods.

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