Edited Minutes of the Monetary Policy Committee Meeting (No. 5/2017)

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Members Present

Veerathai Santiprabhob (Chairman), Mathee Supapongse (Vice Chairman), Paiboon Kittisrikangwan, Porametee Vimolsiri, Sethaput Suthiwart-Narueput, and Apichai Boontherawara

Member Absent

Jamlong Atikul

The Global Economy

The growth outlook of Thailand's trading partners improved slightly from the previous meeting with stronger growth momentum. The **US economy** was projected to continue expanding driven by improvements in private consumption and investment despite some decline in private sector confidence as a result of political risks. The **euro area economy** recorded a stronger expansion thanks to higher production and domestic spending, with growth beginning to broaden to periphery countries. **Japan** continued to grow at a gradual pace on the back of exports and domestic consumption, while indicators of capital expenditure showed signs of improvement. **Asian economies** continued to recover thanks to exports, with signs of positive spillovers to investment and employment seen in some countries. Nevertheless, private consumption was still slowly recovering and held back by elevated household debt in some countries. Looking ahead, Asian exports were expected to moderate somewhat in line with the slowdown in the **Chinese economy** due to ongoing economic structural reforms. Although the growth outlook of most trading partners improved, inflation was rising only slowly and was still below target in most economies. Hence, **most central banks kept the policy interest rates unchanged over the inter-meeting period**. While the Federal Reserve remained on the path of monetary policy normalization, concerns regarding low inflation led market participants to anticipate a more gradual hike in the federal funds rate. In addition, some central banks employed additional tools to maintain economic and financial stability, such as macroprudential measures to address risks in the real estate sector, and the accumulation of foreign reserves as a buffer against future shocks, especially if advanced economies were to increase policy rates faster than expected.

The Committee assessed risks to global economic recovery to have declined on both the upside and the downside. In particular, upside risks decreased as the swift implementation of US economic stimulus policies became less likely. Downside risks also declined, given the assessment that Chinese authorities would be able to manage risks to economic and financial stability that might arise from ongoing economic structural reforms. Meanwhile, downside risks associated with uncertainties surrounding US economic and foreign trade policies and global geopolitical risks was largely unchanged, and thus the balance of risks to global growth remained skewed downward. Some Committee members also noted that, even if the Chinese authorities could effectively manage economic and financial stability risks, there remained uncertainty about a slowdown in economic activities in the short run.

The Financial Markets

Overall sentiments in global financial markets picked up on the back of the improved growth outlook in many countries, especially in the euro area, although there were periods of heightened concerns due to rising tensions in the Korean peninsula**.** At the same time, investor sentiments towards the US dollar were negatively affected by rising US political risks, lower probability that economic stimulus policies in the US would proceed as the market expected, and weaker-than-expected economic data. **Combined with accommodative global financial conditions, such developments resulted in continued capital inflows to regional bond markets**. Consequently, the **baht appreciated against the US dollar** from the previous meeting. The **Nominal Effective Exchange Rate (NEER)** also strengthened despite relatively smaller capital inflows to Thailand compared with other countries in the region because, in the latter half of July, Thai corporates and foreign affiliates obtained a large amount of financing abroad, and Thailand's current account recorded a larger surplus than what the market expected. Nevertheless, the Real Effective Exchange Rate (REER) appreciated less relative to the NEER, given that Thailand's inflation was lower compared with trading partners. The Committee viewed that the stronger appreciation of the baht relative to those of regional currencies in some periods might affect business adjustments and thus would continue to closely monitor developments in the foreign exchange market going forward.

With regard to the bond market, short-term **government bond yields** decreased and fell below the policy rate in some periods. This was mainly a result of the reduction in issuances of short-term BOT bonds and treasury bills. The Committee noted that the decline in short-term yields had no bearing on the future monetary policy stance which would be primarily conditioned on the outlook of inflation, economic growth, and financial stability. The Committee also expected that short-term yields would not decline further, given that some investors already made portfolio adjustments and that the government would resume issuing treasury bills at the beginning of the next fiscal year.

Domestic Economic Conditions

The Thai economy was projected to continue expanding driven mainly by merchandise exports and tourism. **Merchandise exports** recorded stronger growth across various export destinations and product categories, consistent with faster economic growth among Thailand's trading partners. Such improvements in the export outlook were observed for exporting firms of all sizes, both large corporates and small-and-medium sized enterprises (SMEs). Meanwhile, **tourism** continued to expand thanks to increases in the number of tourists from China and ASEAN countries. Nevertheless, growth in domestic demand lagged behind external demand. **Private consumption** was projected to expand at a gradual pace, supported in part by improvements in farm income that resulted from higher agricultural output during periods of favorable weather conditions. However, elevated household debt still weighed on private consumption. Meanwhile, overall labor income had yet to increase, despite improvements in employment and hours worked in overtime seen particularly among export-related businesses. Under the Committee's view, private consumption and consumer confidence had not yet shown a strong recovery overall. **Private investment** was expected to slowly recover. Higher level of investment in machinery and equipment was observed among export-oriented businesses with good growth performances, with some capital outlays spent on the adoption of automation systems to enhance production efficiency. Construction outlays, however, declined in tandem with the slowdown in the real estate sector.

Public expenditure slowed somewhat due to delays in the disbursement of the additional budget for the fiscal year 2017 as well as revisions to the investment plans of some state-own enterprise projects.

Going forward, the Committee would continue to monitor certain issues and their impacts on the overall growth outlook. First, preliminary assessments of the **flood in the northeastern region of Thailand** indicated that its impact on industrial and commercial areas was limited in scope and size. Regarding the impact on agricultural output and farm households, the Committee assessed that the flood would cause a loss of approximately 7.5 billion baht. Despite a limited impact on the overall economy, the consequence on the well-being of citizens in the affected areas were quite significant. Second, the **more stringent regulations on immigrant workers** might affect business sectors employing a high proportion of immigrant labor, in particular smaller firms in construction, agricultural, and agro-manufacturing sectors that faced greater difficulties in making business adjustments compared with larger firms. On the whole, the net impact of the regulations would depend on how employers would adapt, labor substitutability among remaining workers, and labor productivity in each manufacturing sector. Under the Committee's assessment, there would be some immigrant workers permanently exiting the labor market, and thus a clear policy direction on how the government would manage the situation going forward would be critical. Third, the Committee would monitor the ability to adapt and conform of both consumers and financial institutions to the **recent regulations on credit cards and personal loans under supervision**. The overall impacts of these new rules on private consumption were expected to be limited, given that the measures would apply only to new loans and that these measures had taken into consideration consumer behavior regarding the use of credit cards and personal loans. The Committee also engaged in an extensive discussion on the economic outlook. In particular, **tourism** growth might slow down from supply-side factors such as the limited airport capacity to accommodate the significant increases in flights and passenger arrivals. The expansion of airport capacity could therefore be consequential, along with an emphasis on policies aimed at improving tourism quality in attracting high-income tourists rather than those aimed at increasing tourist numbers. Nevertheless, such policies would require some time to be implemented.

Headline inflation was projected to rise but at a slightly slower pace than previously assessed mainly because of **supply-side factors**. In particular, fresh food prices declined given the abundant supply of vegetables and fruits thanks to favorable weather conditions; low inflation was also due to last year's high base following the drought. Meanwhile, demand-pull inflationary pressures remained low. In addition, the government decided to continue subsidizing prices of liquefied petroleum gas (LPG) using the State Oil Fund for some periods, even after the launch of the LPG price liberalization on 1st August 2017. Nevertheless, headline inflation was projected to gradually rise in the latter half of the year as downward supply pressures dissipated and as domestic demand recovered. In addition, there were upside risks to inflation including excise tax increases and higher labor costs that might result from tighter labor market conditions following the recent regulations on immigrant workers. Nonetheless, downside risks remained given that economic growth might be lower than expected if domestic demand did not exhibit a strong recovery. **Core inflation** increased slightly from the previous month and was expected to slowly rise in tandem with the recovery in domestic demand. Meanwhile, the public's **inflation expectations** remained close to the midpoint of the target. Looking ahead, some Committee members noted that headline inflation in the latter half of this year might be softer than expected given that agricultural output, especially rice, would likely be high.

Growth in commercial bank loans increased mainly on the back of business loans, in particular loans extended to real estate and export-related sectors. In terms of size, credit expansion was observed for both large corporates and SMEs, with a relatively stronger growth for the former. Nevertheless, such expansion of business credits did not fully reflect new investment, as new credits were mostly for working capital and financial restructuring purposes, consistent with the slow recovery in private investment. Consumer loans remained largely stable with a resumption in auto loans being observed. In addition, the approval rate for business loans increased in tandem with higher loan demand especially among those with larger credit lines. Meanwhile, commercial banks remained cautious in extending loans to households. **Credit quality** deteriorated due to loan defaults by some large corporates, but the non-performing loans (NPL) ratio was largely unchanged as banks also wrote off debts from their balance sheet during this period. Notably, the NPLs for medium-sized businesses started to decline; however, NPLs for smaller businesses in the commercial sector continued to rise. In any case, financial institutions maintained high levels of loan loss provision and capital buffers, which provided cushion against deterioration in credit quality. The Committee saw the need to closely monitor NPLs of loans extended to small enterprises. Some members were of the view that the decline in NPLs of SME loans in export-related sectors could be partly attributed to export growth seen in firms of various sizes.

Financial stability remained sound but there were pockets of risks that continued to warrant close monitoring. The ratio of household and corporate debt to GDP was projected to decline, consistent with the gradual recovery in private consumption and private investment. Nevertheless, there were risks associated with debt serviceability of firms, particularly SMEs, and households. In the real estate sector, risks from the oversupply of condominiums in Bangkok and vicinities remained stable, but the situation in certain areas with elevated unsold condominium inventory and longer time estimated to deplete inventory must still be monitored as well as developments of large mixed-use projects that were launched recently, and their implication for oversupply in the property market especially from 2020 onward when these projects were expected to be completed and open for sale. Meanwhile, risks pertaining to the rollover of unrated bonds eased somewhat, although debt serviceability and the ability to roll over maturing debt of risky issuers continued to warrant monitoring in the period ahead. Furthermore, some Committee members viewed that the market started to adapt as reflected in increased financing costs for riskier businesses, and the fact that mutual funds exercised greater caution when investing in unrated bonds. In the period ahead, it would be essential to have a closer cooperation between various regulatory agencies to develop mechanisms that would enforce market discipline among bond issuers in order to facilitate better risk assessments on the part of the stakeholders. In addition, the Committee noted that, while the ratio of household debt to GDP continued to decline, private consumption was still expanding only slowly despite the fact that the Thai economy as a whole continued to expand. This could be partly because household income growth lagged behind GDP growth. As a result, household debt relative to income might not yet decline.

The search-for-yield behavior in the prolonged low interest rate remained present as reflected in (1) the continued expansion in foreign investment funds (FIFs), although risks were limited as most funds invested in countries with investment grade credit rating, and (2) the increase in the asset size of saving cooperatives following expansion in deposits.

Furthermore, some saving cooperatives accepted deposits from associate members in addition to regular members. This might prompt saving cooperatives, especially those with available funds exceeding member's loan demand, to seek higher yields by investing in riskier assets.

<u>Monetary Policy Decision</u>

The Committee assessed Thailand's growth outlook to have gained further traction mainly on account of external demand. Meanwhile, the expansion of domestic demand was not yet sufficiently strong, although positive spillovers from export growth were observed in other parts of the economy. While headline inflation softened and might fall below the lower bound of the target in some periods mainly because of supply-side factors, it was projected to slowly rise in the latter half of this year. Core inflation remained low. Consequently, the Committee viewed that the current level of monetary policy accommodation was still needed to support domestic demand growth in order to close the output gap and to facilitate a gradual return of headline inflation to target in the period ahead. In addition, the Committee viewed that the effect of a policy rate cut to foster a swifter return of inflation to target would be limited. This was because the decline in inflation was attributed mainly to supply-side factors and might partly be a result of structural factors. At the same time, a policy rate cut at the current juncture might exacerbate financial stability risks given the prolonged low interest rate environment.

In their policy deliberation, the Committee discussed key considerations underpinning policy decision. Their conclusions were as follow.

(1) Thailand's growth outlook was expected to gain further traction mainly on account of merchandise exports and tourism, while domestic demand expanded at a gradual pace. Benefits from the export expansion were limited to some business sectors and still did not lend support to income and employment in the broader economy. Hence, private consumption and investment growth was not sufficiently strong. The Committee also viewed that the ongoing economic expansion had not yet broaden to domestic-oriented SMEs and low-income households. Moreover, some Committee members expressed concerns on short-term adjustments by businesses from the impact of more stringent regulations on immigrant workers. Overall, the Committee viewed that an accommodative monetary policy stance was still needed at the current juncture to support a more robust economic expansion.

(2) Headline inflation softened due mainly to supply-side factors but retained an upward trajectory in the latter half of this year. The Committee was concerned with sluggish headline inflation but anticipated that it would gradually rise. In this regard, maintaining the current level of monetary policy accommodation would be conducive to returning inflation to target over the medium term, although this process might take some time. Meanwhile, a few Committee members added that deflation risks remained low given that the economy still continued to expand, prices of most goods and services either picked up or remained stable, and medium-term expectations remained close to the midpoint of the target.

(3) Financial stability remained sound overall but there remained pockets of risks that continued to warrant monitoring. Most Committee members expressed concerns regarding the rising NPLs especially among small businesses which partly reflected their limited ability to adapt to competition and structural changes. Meanwhile, some Committee members were concerned that the declining household debt-to-GDP ratio might not reflect deleveraging given that private consumption did not improved significantly in the recent periods.

Most Committee members were also concerned with the search-for-yield behavior which became more prominent in the environment where the policy rate remained low for an extended period. This was partly reflected in increased investment in riskier assets relative to commercial bank deposits, including investment in foreign investment fund (FIFs), deposits at saving cooperatives, and unrated bonds, which could coincide with underpricing of risks. Moreover, there remained the need to monitor trend of short-term financing by businesses, especially those in sectors with long term investment projects which could result in possible maturity mismatch. Increased competition in lending to larger firms, both among banks and between bank and the bond market, must also be monitored as it might lead to excessively low financing costs for large firms and potential underpricing of risks. In addition, there could be other financial stability problems that remained undetected, especially those stemming from regulatory gaps. It would therefore be essential that financial regulatory authorities coordinate more closely to ensure that macroprudential measures could be implemented in an appropriate and timely manner.

In this light, the Committee unanimously voted to keep the policy rate unchanged at 1.50 percent at this meeting and concurred on the need to maintain accommodative monetary policy stance to support the continuation of economic growth while preserving financial stability.

Monetary Policy Group
30 August 2017