BANK OF THAILAND

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Monetary Policy Report, June 2017

Mr. Jaturong Jantarangs, Assistant Governor of the Bank of Thailand (BOT) and Secretary of the Monetary Policy Committee (MPC), released the June 2017 issue of the *Monetary Policy Report*. The *Report*, published quarterly, is aimed at enhancing public understanding of the MPC's policy stance and its assessment of Thailand's economic outlook. Details are summarized as follows.

1. Global Economy

The global economy was projected to continue expanding. The U.S. economic growth outlook remained positive as consumption rebounded after a slowdown in the first quarter of the year due to temporary factors. Euro area economies continued to recover. Domestic demand was underpinned by accommodative monetary policy, improved labor market conditions, and reduced political uncertainties after a pro-EU political party claimed victory in the French presidential election; the recovery was also driven by improvements in exports thanks to global trade recovery. Meanwhile, the Japanese economy was recovering at a gradual pace on the back of a better export outlook. China continued to expand in the first quarter thanks to exports but was expected to slow down as a result of the ongoing economic structural reforms. Asian economies other than Japan and China continued to recover on the back of exports, especially electronics and commodities, which were driven by global demand. **Trading partners' headline inflation was expected to edge up slowly** while core inflation remained broadly stable. Overall, the **growth forecast for Thailand's trading partners was revised up. However, risks on the external front still tilted to the downside** in the medium term because of uncertainties surrounding U.S. economic and foreign trade policies, China's economic structural reforms, and global geopolitical risks.

Most central banks kept their policy rates on hold given the sluggish inflation outlook. On the other hand, the Federal Reserve raised the federal funds rate and announced its plans for balance sheet normalization following the Federal Open Market Committee (FOMC) meeting in June. In the period ahead, volatility in the global financial markets would likely remain high. Volatile capital flows, both into and out of emerging markets, might result from monetary policy actions of major advanced economies and uncertainties surrounding the U.S. economic stimulus policies.

Crude oil prices declined due mainly to supply-side factors, namely the increased oil output from U.S., Libyan, and Nigerian producers. Going forward, oil prices would slowly rise in tandem with the global economic recovery and production cuts by major oil producers. The Committee therefore revised the projection for the Dubai crude oil price down to an average of 50.9 U.S. dollars per barrel in 2017 before gradually edging up to 52.8 U.S. dollars per barrel in 2018.

2. Recent Economic Developments

The Thai economy continued to expand in the first quarter of 2017. Private consumption grew gradually, despite strong expansion of merchandise exports in a broader set of products. Government spending and tourism sector continued to be important growth drivers. Meanwhile, private investment contracted. However, **headline inflation slowed down in the second quarter** primarily due to supply-side factors. Particularly, fresh food prices sharply declined as a result of last year's high base following the drought coupled with this year's higher agricultural output thanks to favorable weather conditions. Energy prices also fell as a result of lower global oil prices.

Financial conditions remained accommodative. In the second quarter of 2017, Thai government bond yields of all, especially longer, tenures declined to a level below those at the end of last year. Financing costs through commercial banks decreased following cuts in commercial bank benchmark retail lending rates. Meanwhile, business financing through credit and bond markets continued to expand. Commercial bank loans picked up in the first two months of the second quarter mainly from business loans extended to large corporates, while loans to households rose across most loan purposes except credit card loans. With regard to exchange rates, the baht against the U.S. dollar appreciated in line with regional currencies due to the weakening of the U.S. dollar and increases in capital inflows into emerging markets including Thailand.

Financial stability remained sound overall, but there remained pockets of risks that warranted monitoring. The ratio of household debt to GDP trended down. However, the uneven economic recovery and structural problems faced by some business sectors undermined debt serviceability of both households and businesses, particularly SMEs. However, financial institutions maintained high levels of capital buffers and loan loss provisions to cushion against risks stemming from deteriorating credit quality. Regarding the real estate sector, a sharp increase in condominium prices as seen in earlier periods appeared less likely. Property developers and financial institutions were more cautious given slowing demand and large excess supply in some areas. Nevertheless, the existing level of real estate supply is deemed manageable by the property developers. Meanwhile, the search-for-yield behavior in the prolonged low interest rate environment remained present and might lead investors to underprice risks.

3. Economic Outlook

Looking ahead, Thailand's economic growth was projected to gain further traction and record 3.5 percent in 2017 and 3.7 percent in 2018. This upward revision to the previous forecast was mainly on account of the pickup in merchandise and services exports. Meanwhile, private sector domestic demand continued to expand at a gradual pace.

The expansion in merchandise exports was more broad-based across product categories and export destinations. The value of merchandise exports in 2017 was projected to grow by 5 percent, an upgrade from last year's 0.1 percent growth. Export growth was expected to be driven particularly by exports of electronics that benefited from the increasing popularity of smartphones and Internet of Things (IoT) devices. Nonetheless, electronics export growth might soften somewhat in the period ahead as China's production of electronics started to slow down following prior acceleration to support the introduction of new smartphone models last year.

Exports of services recovered swiftly and were expected to continue expanding. The Committee revised up the projection for the number of foreign tourists in 2017 to 34.9 million, as the number of Chinese group tourists recovered swiftly from the impact of the measures to curb illegal tours toward the end of last year. Moreover, Thai tourism also benefited from the opening of new direct flight routes from China to major tourist destinations in Thailand and also from the Chinese government's restrictions on package tours to South Korea which diverted a portion of Chinese tourists to Thailand.

Public expenditure remained a key economic driver. Budget disbursement for both public consumption and public investment was well on track despite some unexpected delay for certain projects such as provincial development, new motorways, dual-track rails, and some new mass-transit lines under the government's infrastructure investment plan.

Private consumption expanded at a gradual pace, supported by improvements in farm income, together with employment in services and export-related manufacturing sectors that was expected to gradually increase. However, overall purchasing power had yet to fully recover as both employment and household income in the manufacturing sector did not benefit much from the export recovery, while the use of automation in place of manual labor was on the rise. In addition, elevated household debt continued to cause consumers to continue their cautious spending pattern, especially among lower income households with weaker debt serviceability than other income groups.

Private investment was projected to slowly recover. In the near term, investment expenditure to expand production capacity was observed in export-oriented manufacturing sectors especially electronics. However, outlays for construction trended down in tandem with the slowdown in the property market. In the period ahead, growth in consumption and exports, together with continued public investment, were expected to support the recovery in private investment.

Headline inflation remained low due to supply-side factors but was expected to gradually rise in tandem with demand-pull inflationary pressures that were expected to slowly increase given the improved growth outlook. However, inflation was still held down by oil prices, which were projected to remain largely unchanged or increase slowly, and also by sluggish increases in fresh food prices. The latter was attributable to (1) cyclical factors such as commodity food prices which stabilized at low levels and (2) structural factors such as the development of new manufacturing production and irrigation technology. **The Committee therefore revised down its forecasts for headline inflation to 0.8 and 1.6 percent in 2017 and 2018, respectively.**

The balance of risks to growth remained tilted to the downside and was largely unchanged from the previous assessment. While growth of overall trading partners' economies and global trade improved, risks on the external front remained. These included uncertainties pertaining to the U.S. foreign trade policy and geopolitical risks, both of which could have adverse economic impacts on Thailand's trading partners. However, there were still some possibilities that the Thai economy would achieve higher growth than the baseline projection if the U.S. economy were to exhibit stronger-than-expected growth due to stimulus measures. In contrast to the balance of risks to growth, the **balance of risks to inflation tilted to the upside** as more stringent regulations on immigrant workers could further tighten labor market conditions and in turn raise labor costs for businesses. The extent of the upside risk would depend on the implementation and management by the authorities.

4. <u>Monetary Policy Deliberation</u>

In the Monetary Policy Committee meetings on 24 May and 5 July 2017, the Committee unanimously voted to maintain the policy interest rate at 1.50 percent. In deliberating their policy decision, the Committee viewed that Thailand's economic growth continued to gain further traction driven by the external sector. Private consumption was expected to recover at a gradual pace. Meanwhile, headline inflation this year was projected to be lower than the previous assessment mainly due to supply-side factors. Nevertheless, inflation still retained an upward trajectory overall and was projected to rise in tandem with economic growth and domestic demand recovery.

Financial conditions remained accommodative and helped support economic growth overall. Financing costs decreased after a number of commercial banks cut their benchmark retail interest rates. At the same time, declines in bond yields also contributed to more accommodative financial conditions. Meanwhile, the baht's appreciation over the recent period was in line with movements of other regional currencies, and the Committee would to continue to monitor short-term capital flows going forward.

Financial stability remained sound. However, there remained pockets of risks that warranted monitoring such as the debt serviceability of SMEs that had yet to improve which in part reflected competitiveness issues. Meanwhile, the search-for-yield behavior in the prolonged period of low interest rates remained present as reflected by a continued increase in asset sizes of foreign investment funds (FIFs). Nonetheless, risks pertaining to FIFs were still limited as their investments were mostly in the form of deposits or short-term bonds in countries with good credit rating. In addition, investment in unrated bonds subsided following earlier defaults by some issuers, but the bond market overall underwent orderly adjustments. Going forward, the Committee viewed that close collaboration among regulatory agencies would be a key mechanism for effective monitoring, assessment, and management of various risks in the increasingly interconnected financial system, as it would reduce regulatory gaps and allow risks to be addressed in a more efficient and timely manner.

Monetary policy should remain accommodative to support the continuation of economic growth and to facilitate the return of headline inflation toward the target. While Thailand's growth outlook improved, the expansion of domestic demand was not yet sufficiently broad-based and the economy was still faced with risks on the external front. Inflationary pressures remained low and headline inflation this year might average below the target despite retaining an upward trajectory. Meanwhile, financial conditions eased and financial stability remained sound. In this light, the Committee concurred that the degree of monetary policy accommodation should be maintained for some time so that economic growth could continue and become more broad-based, which would enable headline inflation to return to target in a sustainable manner. The Committee would stand ready to utilize an appropriate mix of available policy tools to achieve these policy goals while also ensuring financial stability.

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