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Monetary Policy Report, September 2017

Mr. Jaturong Jantarangs, Assistant Governor of the Bank of Thailand (BOT) and Secretary of the Monetary Policy Committee (MPC), released the September 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. Advanced economies continued to gain further traction driven mainly by expansion in consumption and stronger labor markets. The U.S. economic growth outlook improved further on the back of private consumption given strong labor market conditions and improved household financial positions and consumer confidence. Euro area economies recorded stronger expansion, with growth broadening across most member countries thanks to accommodative monetary policy stance and a recovery in consumer confidence and labor market conditions. Japan also continued to expand as private consumption picked up due to an increase in wages, improved consumer confidence, and accommodative monetary policy. The expansion was also driven by growing exports thanks to global trade recovery. Meanwhile, emerging economies in Asia continued to grow on the back of improvements in exports, which were underpinned by global demand and technological cycle of electronic goods. In addition, private consumption continued upward trajectory as consumer confidence gradually improved, although such improvement was not robust given elevated household debt levels. The Chinese economy would likely grow at roughly the same pace but was expected to gradually slow down as the economic structural reforms began to bear results. Overall, **the growth forecasts for Thailand's trading partners were revised up**. However, there remained risks that warranted monitoring such as uncertainties pertaining to U.S. economic and foreign trade policies, economic and financial stabilities concerns in China, and geopolitical risks.

Most central banks maintained their accommodative monetary policy stances, although a few central banks raised their policy rates. As for the Federal Reserve (Fed), the Fed was expected to commence its balance sheet reduction and gradually raise its federal funds rate, as the U.S. economy was approaching full employment and headline inflation was projected to slowly rise. However, central banks of some Asian countries, namely Vietnam, India, and Indonesia, cut their policy rates in order to support further growth.

Crude oil prices remained stable but would slowly rise going forward in tandem with global economic recovery and production cuts by major oil producers. The Committee therefore maintained the projection for Dubai crude oil price at 50.9 and 52.8 U.S. dollars per barrel in 2017 and 2018, respectively.

2. <u>Recent Economic Developments</u>

The Thai economy gained further traction in the second quarter of 2017. The growth was primarily driven by external demand from both exports and tourism with signs of greater positive spillovers to domestic demand. Meanwhile, private consumption continued to grow in line with spending on services and durable goods. Public spending remained an important growth driver. Moreover, **headline inflation increased somewhat in the first two months of the third quarter** due to higher domestic retail oil prices and energy charges (FT), while core inflation was largely unchanged from the previous quarter.

Financial conditions remained accommodative. Most short-term money market rates remained close to the policy rate. However, Thai government bond yields declined across all tenures, particularly short-term bond yields that fell significantly in July following the reduction of the Bank of Thailand's short-term bond issuances and a suspension of treasury bill issuance by the government at the end of the fiscal year. However, yields began to pick up due to market adjustments. Meanwhile, the decline in medium-term and long-term yields was influenced by external factors including a slower-than-expected rise in the federal funds rate and conflicts in the Korean Peninsula. With regard to financing costs, the new loan rate remained stable at a low level after having declined in the previous period. Private credit expanded due to an increase in loans extended to households and large corporates in export- and tourism-related businesses. In addition, business financing through equity market continued to expand, although funding through the bond market contracted somewhat as matured debts of some telecommunication and energy companies were not replaced by new debt issuances. With regard to exchange rates, the baht appreciated against the U.S. dollar from the previous quarter. This was attributable to the weakening of the U.S. dollar and other domestically driven factors such as higher-than-expected current account surplus and sizable foreign direct investment flows into Thailand in this quarter. Nevertheless, the baht's movement relative to those of trading partners was largely unchanged.

Financial stability remained sound overall but there remained pockets of risks that might result in the buildup of vulnerabilities in the financial system going forward. External stability continued to be strong while financial positions of large corporates and financial institutions remained sound. Financial institutions maintained high levels of capital buffers and loan loss provisions to cushion themselves against risks. Nevertheless, there remained pockets of risks that could potentially lead to the buildup of vulnerabilities in the financial system going forward. These included (1) debt serviceability of both households and businesses that remained fragile, (2) search-for-yield behavior, and (3) oversupply of condominium units in Bangkok and vicinity areas as well as large-scale mixed-use real estate developments.

3. Economic Outlook

Looking ahead, the Thai economy was projected to expand further, recording 3.8 percent in 2017 and 2018. The upward revision to the previous forecast was on account of a continued improvement in merchandise exports and tourism. In addition, private spending gradually rose and was more broad-based while fiscal impulse remained.

The expansion in merchandise exports was more broad-based across product categories and export destinations, with improvements seen across exporting firms of all sizes. The value of merchandise exports in 2017 was projected to grow by 8 percent in tandem with global economic recovery. Exports of electronics would likely expand in line with the technological cycle, while several products also benefited from the relocation of production bases to Thailand. Moreover, export prices were also projected to trend up, especially commodities, in line with crude oil prices. Nevertheless, the exports expansion would likely raise demand for raw materials and intermediate goods, prompting this year's import value to rise further.

Exports of services continued expanding in tandem with stronger performance of the tourism sector. The projection for the number of foreign tourists in 2017 was revised up from 34.7 to 35.6 million due to several reasons: (1) increasing number of Chinese tourists—both group and independent tourists—thanks to the opening of new direct flight routes from China to major tourist destinations in Thailand, (2) a rising number of ASEAN tourists that was in line with economic recovery, and (3) the reduction and exemption of tourist visa fees. Moreover, global economic recovery helped support a further rise in tourism spending per head.

Private consumption would expand at a gradual pace in the period ahead, supported by improvements in farm income and employment in export-related manufacturing and services sectors as well as government measures such as the social welfare card project and the 9101 Project. However, household purchasing power would remain modest going forward because employment and wages had yet to fully benefit from the export recovery, partly due to economic structural changes and business models that were less reliant on labor, together with elevated level of household debt.

Public spending remained an important growth driver. Budget disbursement for both public consumption and investment was well on track despite some unexpected delay in certain projects such as investment projects of state-owned enterprises. Meanwhile, government investment was expected to slow down after prior acceleration, while some government agencies were constrained by limited disbursement efficiency. In addition, the promulgation of the Public Procurement and Supplies Management Act B.E. 2560 might result in a delayed disbursement, during the initial phase, of some state agencies that would now be governed by the new law, particularly local administrations that had not previously operated under this system.

Private investment continued to recover albeit at a gradual pace. In the near term, investment recovery was observed in various industries, consistent with an expansion in private consumption and exports. However, there remained excess production capacity in some businesses as they were also awaiting for greater clarity in the government's stimulus policies especially those regarding some infrastructure investment projects.

Headline inflation remained low due to supply-side factors but was expected to slowly rise. In recent periods, headline inflation was lower than previously assessed attributed largely to supply-side factors, especially fresh food prices. Moreover, the lower fresh food prices also helped hold down the food component in core inflation at low level. Going forward, inflation was expected to edge up slowly on the back of the gradual increase in demand-pull pressures given the improved growth outlook and higher cost-push pressures from an increase in excise tax, higher wages from the new regulations on immigrant workers, and the minimum wage rise next year. However, structural factors such as e-commerce and globalization trends, which intensified competitions among businesses, coupled with lower production costs driven by technological advancements, would likely cause inflation to rise at a gradual pace overall. **The Committee therefore revised down its forecasts for headline inflation to 0.6 and 1.2 percent in 2017 and 2018, respectively.**

Risks to growth became more balanced in the near term, albeit still tilted to the downside, while risks to inflation were judged to be balanced. Uncertainties surrounding the growth forecasts decreased given the better growth outlook of Thailand's trading partners. However, there were possibilities that growth outturn might be lower than the baseline projection owing to uncertainties pertaining to U.S. foreign trade policy, China's ongoing economic structural reforms, and geopolitical risks, all of which could have adverse impact on Thailand's trading partners. On the domestic front, downside risks stemmed from household purchasing power that was not yet broad-based, the stringent regulations on immigrant workers that might affect economic activities, and a possible slowdown in public spending during an initial phase of Public Procurement Act adoption. On the upside, there were possibilities that the Thai economy would achieve a higher growth than the baseline projection given a stronger-than-expected growth of the U.S. economy due to domestic stimulus measures. Unlike the balance of risks to growth, the risks to inflation were projected to be in balance, with downside risks that inflation might fall below the baseline projection coming from a lower-than-projected economic growth and the impact of structural changes from technological advancements and intensifying business competitions. However, on the upside, inflation might be higher than baseline projection should regulations on immigrant workers result in a tightening labor market and wages increases.

4. Monetary Policy Deliberation

In the Monetary Policy Committee meetings on 16 August and 27 September 2017, the Committee unanimously voted to maintain the policy interest rate at 1.50 percent. In deliberating their policy decision, the Committee assessed economic growth to

continue to gain further traction, driven mainly by external sectors with signs of greater positive spillovers across various sectors of the economy. Domestic demand started to improve; however, supporting factors to consumption were not yet robust. Meanwhile, headline inflation was projected to be below the lower bound of the target this year due to supply-side factors, especially the decline in fresh food prices and structural factors that were observed in many countries. However, inflation was projected to slowly rise in tandem with economic growth and domestic demand recovery.

Overall financial conditions remained accommodative and conducive to economic growth. Short-term government bond yields declined mainly as a result of the reduction in short-term bond issuances by both the Bank of Thailand and the Ministry of Finance and did not indicate future monetary policy stance. Meanwhile, the Thai baht appreciated somewhat against the U.S. dollar, but the baht's movement was largely unchanged relative to those of trading partners. Nevertheless, the baht experienced stronger appreciation compared with regional currencies in some periods due to Thailand's external positions and other specific domestic factors. Going forward, the Committee viewed that the baht might experience high volatilities due to uncertainties from the external front. Therefore, the Committee would closely monitor developments in the foreign exchange market.

Financial stability remained sound overall, but there remained pockets of risks that might lead to the buildup of vulnerabilities in the period ahead. These risks included deterioration in debt serviceability of households and SMEs stemming from elevated debt levels and structural problems that weighed on SMEs' adjustments amid a changing environment in business competitions. In addition, even though the situation regarding the rollover of the unrated corporate bonds improved, there were still pockets of risks that warranted monitoring including the debt serviceability of bonds that would mature in the period ahead and maturity mismatch in business financing structures, especially those in the real estate sector. In addition, the prolonged low interest rate environment not only could affect national savings but also could increase the search-for-yield behavior, as reflected in a continued increase in investments in financial assets abroad that were concentrated in some countries as well as the search-for-yield behavior of saving cooperatives. Consequently, these might lead to widespread underpricing of risks. The Committee would thus continue to monitor developments of such risks; furthermore, the Committee viewed that developments of financial market infrastructure and collaboration among regulatory authorities would be crucial in enabling better information access for risk assessment and preventing any exploitation of the regulatory gap. The Committee would stand ready to implement appropriate macroprudential measures in a timely manner.

Monetary policy should remain accommodative to support the continuation of economic growth and spillovers to domestic demand, which would help increase inflationary pressures in the period ahead. The Committee assessed that Thailand's economic growth continued to gain further traction on the back of both external and domestic factors, though there remained risks to the external front that could affect export and tourism growth.

Moreover, domestic demand that was not yet sufficiently strong, coupled with certain supply-side and structural factors, led to low inflationary pressures. Meanwhile, financial conditions remained accommodative with sound financial stability. The Committee viewed that the degree of current monetary policy accommodation should be maintained to support further economic growth and spillovers to domestic demand. These would facilitate the increase in inflationary pressures and the return of headline inflation to target, although this might take some time. The Committee would stand ready to utilize an appropriate mix of available policy tools to support economic growth while ensuring financial stability.

Bank of Thailand

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