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Monetary Policy Report, December 2017

Mr. Jaturong Jantarangs, Assistant Governor of the Bank of Thailand (BOT) and Secretary of the Monetary Policy Committee (MPC), released the December 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.

Monetary Policy Conduct in the Fourth Quarter of 2017

While overall economic growth gained further traction in the fourth quarter of 2017, driven mainly by the external sectors. Meanwhile, the underlying strength of domestic demand and household purchasing power, headline inflation that remained below target, and some pockets of risks to financial stability still warranted monitoring. Against this backdrop, **the Committee had to weigh between sustaining economic growth in order to attain the objective of price stability and preserving financial stability in formulating the most appropriate course of policy action. The Committee also assessed the benefits and costs of different policy options and unanimously voted to keep the policy rate unchanged at 1.50 percent at the meetings on November 8 and December 20, 2017.** In deliberating their decisions, the Committee judged that accommodative monetary policy stance would still be necessary to support the continuation of economic growth. The current policy interest rate remained appropriate in that it would facilitate sufficiently accommodative financial conditions to support economic growth and foster the return of headline inflation to target expected during the first half of 2018.

Looking ahead, the Committee deemed that monetary policy accommodation should be maintained for some time to support more robust economic growth and foster the gradual return of headline inflation toward the medium-term target. The Committee would closely monitor inflation developments and assess structural factors affecting inflation dynamics. The Committee would stand ready to utilize available policy tools to facilitate the return of headline inflation to target in an appropriate time, while seeking to achieve sustainable growth and maintaining financial stability. The Committee also deemed it necessary to develop a process to monitor and assess financial stability risks that could be systematically incorporated in the conduct of monetary policy.

Monetary Policy Target in 2018

The Committee and the Minister of Finance concurred that headline inflation of 2.5 ± 1.5 percent should be the target for the medium term and for 2018. The Cabinet approved the proposed target on December 19, 2017, as this level of inflation would facilitate economic growth to be in line with potential as well as maintain the country's competitiveness. In addition, the tolerance band should be appropriate to provide cushion against shocks that might cause inflation to deviate from target in the short term.

<u>Assessments of the Economic, Inflation, and Financial Stability Conditions and Outlooks as the Basis for Policy Formulation</u>

1. Global Economy

The global economy was projected to continue expanding and remain a driver of Thai exports in the period ahead. Advanced economies expanded further mainly due to consumption and stronger labor markets. Moreover, the U.S. tax policy reform, signed into law toward the end of December 2017, would help stimulate the U.S. economy going forward. The euro area recorded stronger expansion on the back of consumption and exports. In addition, accommodative financial conditions, improved consumer confidence, and a recovery in the labor market would help support consumption spending going forward. Japan continued to expand on account of exports and manufacturing, with consumption expected to increase following improved consumer confidence and labor market conditions. Meanwhile, the Chinese economy was expected to gain further traction despite some slowdown because of financial stability measures implemented by the authorities. However, improving global demand and the government's additional financial measures to support specific groups would facilitate economic growth going forward. Other Asian economies were expected to grow following improvements in exports which would underpin employment and household consumption in the period ahead. **The Committee therefore revised up the growth forecast for Thailand's trading partners to 3.8 percent in 2017.** However, there remained certain risks that warranted monitoring in 2018. These included uncertainties surrounding U.S. economic policies such as trade and infrastructure policies as well as geopolitical risks that could undermine the economy and financial markets.

Most central banks maintained accommodative monetary policy stance. Nonetheless, some central banks raised their policy rates such as the Federal Reserve (Fed), the Bank of England, and the Bank of Korea. The Fed commenced its balance sheet reduction as previously announced and the European Central Bank announced a reduction of monthly bond purchases. Moreover, a number of central banks in Asia started to signal changes in their monetary policy direction, as improved economic growth and a gradual rise in inflation facilitated monetary policy normalization the period ahead.

2. Financial Conditions and Financial Stability

Financial conditions remained accommodative. Short-term bond yields remained below the policy rate due to a decreased supply of short-term bonds. Meanwhile, long-term bond yields edged up on the back of an increase in the long-term bond supply, together with external factors following the progress of the U.S. tax policy reform which could lead to budget deficits. Consequently, U.S. government bond yields were expected to rise and could lead to higher Thai government bond yields. Meanwhile, interest rates on new loans (NLR) remained stable at a low level after trending downward earlier. Overall private credit expanded driven mainly by household loans especially mortgage and auto leasing loans. Corporate loan growth, on the other hand, slowed down especially in the manufacturing and trade sectors in part due to debt repayments of large corporates. However, SME loan growth started to pick up in several sectors and working capital loans to export-oriented businesses continued to expand. Regarding the exchange rates, the baht remained largely unchanged. The real effective exchange rate (REER) appreciated somewhat consistent with improvements in economic fundamentals and was broadly in line with REERs of other countries.

Financial stability remained sound but there remained pockets of risks that warranted monitoring. These included, first, debt serviceability of SMEs and low-income households as the positive spillovers from the economic expansion did not yet broaden out, as reflected in deterioration in credit quality. Second, the search-for-yield behavior that could lead to underpricing of risks needed to be monitored, for example, a continued expansion in foreign investment funds (FIF) that were concentrated in some countries as well as increased investments in riskier assets of some saving cooperatives. Third, there was an oversupply of property developments in some areas, such as condominium units along the MRT Purple Line which have a longer time to go, as well as developments regarding the launches of mixed-used real estate projects that would raise supply in the next 4-5 years.

3. Economic and inflation outlook

The Thai economy was projected to continue expanding and achieve 3.9 percent growth in 2017 and 2018, higher than previously forecasted in the previous quarter. The upward revision was on account of a continued improvement in merchandise exports and tourism, underpinned by growth of trading partners' economies. Private spending gradually expanded and began to be more broad-based. Fiscal impetus also supported growth.

Merchandise exports continued to expand across various product categories and almost all export destinations. The value of merchandise exports in 2017 was revised up to grow by 9.3 percent in tandem with economic expansion of trading partners. Such improvement was particularly observed among exports of electronics, auto parts, and processed agricultural products, thanks to global demand for electrical products and the relocation of production bases to Thailand of some products such as smart phones. Moreover, export prices, especially for commodities, increased in line with oil prices. Meanwhile, import value also rose following an increased demand for raw materials and intermediate goods as well as higher oil prices. However, the exports expansion in 2018 was likely to slow down somewhat due to prior acceleration, together with specific factors such as the rise in exports following the relocation of production bases of some products to Thailand observed this year. However, the monthly average value of merchandise exports was still expected to reach a record high in many years.

Exports of services in 2017 was slightly lower than expected for non-tourism receipts, while tourism sector remained strong. The projection of the number of foreign tourists was revised up to 35.6 million in 2017 and 37.3 million in 2018 due to several reasons: (1) the increasing number of Chinese tourists, both group and independent tourists, due to new direct flight routes, (2) the rising number of ASEAN tourists which was in line with regional economic growth, and (3) a rise in tourism spending per head thanks to global economic expansion and higher-spending tourists.

Private consumption would gradually expand in the period ahead, supported by several factors: (1) improvements in farm income from the previous year due to higher output, (2) improved earnings of workers, especially those in the high-income group, in export-related manufacturing and tourism sectors, (3) maturing debts from the first-car scheme, and (4) government measures such as the social welfare card project. However, the labor market had yet to fully benefit from the economic recovery, partly due to structural changes with increasing adoption of automation, especially in some industries with strong exports. Other factors included migration of labor from the manufacturing sector to the service sector, where productivity and wages were lower, and elevated household debt, particularly of low-income households, for which deleveraging could take some time. Private spending would thus remain modest and might not be sufficiently broad-based going forward.

Public spending remained an important economic driver. Both public consumption and investment expenditure continued to expand despite some unexpected delays in some investment projects, constrained by limited disbursement efficiency and heavy rain which affected construction. Investment projects of state-owned enterprises (SOEs) were mostly on track, although some projects were delayed. Nevertheless, an increase in overall investment budget for 2018 and the holdover of some SOEs investment plans from 2017 would contribute to higher public investment in 2018. However, 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 were not accustomed to the new system such as local administrative organizations.

Private investment continued to recover but was projected to expand at a modest pace. Investment recovery was observed in various industries, which was consistent with expansion in private consumption and exports. However, there remained excess production capacity of some businesses. Nevertheless, infrastructure investment projects and the enactment of the Eastern Economic Corridor Act would be supporting factors for private investment going forward.

Headline inflation remained low due to supply-side factors but was expected to slowly rise. In recent periods, headline inflation was at a low level close to the previous estimate. This was as a result of supply-side factors, namely an increase in output due to favorable weather condition. Going forward, inflation would edge up slowly on the back of a gradual rise in demand-pull pressures, given the improved growth outlook together with the impact from an increase in excise tax. However, inflation might be held down by several factors, such as fresh food prices that would likely remain low thanks to technological advancements and increasing price competition. **The Committee therefore projected headline inflation to be at 0.7 and 1.1 percent in 2017 and 2018 respectively, while core inflation was projected to be at 0.6 and 0.8 percent in 2017 and 2018 respectively. Moreover, the Committee assessed headline inflation to return to the lower bound of the target within the first half of 2018.**

Risks to the growth projection were expected to be in balance with the likelihood that the Thai economy would achieve stronger growth than the baseline projection, given a better growth outlook of Thailand's trading partners due to U.S. economic stimulus measures, China's growth moderation that was orderly, and a continued recovery of Asian exports. Other upside risks included a larger-than-expected public spending following the speedup of infrastructure investment and accelerated spending of funds accumulated by local administrative organizations. On the downside, there were possibilities that the growth outturn might be lower than the baseline projection due to uncertainties pertaining to U.S. foreign trade policy, geopolitical risks, and risks of lower-than-expected domestic spending as improvement in purchasing power was not yet sufficiently broad-based.

Risks to inflation projection were also assessed to be in balance. Upside risks that inflation might be higher than the baseline projection could come from higher crude oil prices on the back of global economic recovery, heightened geo-political risks, and minimum wages increases in 2018. However, on the downside, inflation might fall below the baseline projection from weaker-than-expected demand-pull pressures.

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