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Monetary Policy Report, June 2018

Mr. Jaturong Jantarangs, Assistant Governor of the Bank of Thailand (BOT) and Secretary of the Monetary Policy Committee (MPC), released the June 2018 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 Second Quarter of 2018

The Committee assessed that the Thai economy continued to gain further traction and would achieve higher growth than previously assessed, driven by both domestic and external demand. Headline inflation was projected to increase toward target slightly faster than the previous assessment on the back of rising global oil prices. Demand-pull inflationary pressures edged up somewhat but remained at a low level. Financial stability remained sound but there remained a need to monitor pockets of risks that might pose vulnerabilities to financial stability in the future. **The Committee weighed various factors in determining the most appropriate course of monetary policy and voted unanimously (6 to 0) and later 5 to 1 to maintain the policy rate at 1.50 percent at the meetings on May 16 and June 20, 2018, respectively.** In deliberating their decision, the Committee judged that accommodative monetary policy stance would remained a key supporting factor to help sustain domestic demand growth, which would in turn foster headline inflation to gradually rise and move within the target in a sustainable manner. Under the Committee's assessment, the policy rate at 1.50 percent would be sufficiently accommodative. The new loan rates (NLR) continued to stay at low levels and recent rising government bond yields had a limited impact on financing costs of the private sector. Meanwhile, one Committee member voted to raise the policy rate by 0.25 percentage point to 1.75 percent at the June meeting, with the view that the economic recovery was sufficiently robust and inflation was expected to remain within target throughout the projection period, and that the prolonged monetary accommodation might induce households and businesses to underestimate risks to potential changes in financial conditions. Thus, it would be appropriate to increase the policy rate at this time in order to start building policy space for potential use in the future.

Looking ahead, the Committee viewed that, should economic expansion continue and inflation move more firmly within target, the need for currently extra accommodative monetary policy would start to be reduced, and that the need for a policy rate increase in order to build policy space in the future would be increasing.

Assessments of the Economic and Inflation Outlooks as the Basis for Policy Formulation

1. Global Economy

The global economy was projected to continue expanding amid tightening financial conditions and rising oil prices. Advanced economies would expand on the back of domestic demand. The U.S. economy would be supported by strong economic fundamentals including strong labor market, robust consumer confidence, and fiscal stimulus, despite some impacts from China's trade retaliatory measures. The euro area and Japanese economies would be supported by continued accommodative monetary policy, although the first quarter saw some slowdown in consumption due to unusually cold weather. China continued expanding but growth would slightly slow down due to economic reforms. According to preliminary assessments, the U.S. trade protectionism measures were expected to have some effects on Chinese exports and the overall economy to some extent. Meanwhile, other Asian economies were projected to grow faster than previously estimated owing to robust domestic demand and export growth, which were in line with global demand and international trade. **The Committee, therefore, revised up the growth forecast for Thailand's trading partners from 3.7 percent to 3.8 percent in 2018.** Yet, there remained risks to be monitored, including (1) intensifying trade retaliations between the U.S. and major economies that could undermine trade volume, investment climate, and spur financial market volatility and (2) geopolitical risks which continued to create uncertainty that might affect the global economy and financial markets.

While most central banks maintained accommodative monetary policy stance, the U.S. Federal Reserve (Fed) and some central banks in the region increased their policy rates. For instance, central banks of the Philippines and Indonesia raised interest rates to curb inflation and volatility in the financial markets. In addition, other central banks in the region started to signal changes in monetary policy stance given improved economic growth and rising inflation toward target. Such conditions would facilitate monetary policy normalization in the period ahead.

Global financial markets remained volatile. Emerging markets experienced capital outflows as foreign investors reduced their investments in risky assets. The 10-year U.S. treasury yields reached the highest point in the past four years. The number of Fed's rate hikes this year was expected to increase to four instead of three. In addition, trade retaliatory measures between the U.S. and major economies were intensified. These events increased risks to emerging markets, especially those with weaker economic fundamentals such as Argentina and Turkey.

2. Financial Conditions and Financial Stability

Thailand's financial conditions remained accommodative. Short-term Thai government bond yields rose toward the policy rate due to a greater supply of bonds and lower demand from foreign investors. Meanwhile, medium- and long-term bond yields increased mainly due to external factors as well as Thai economic and inflation outturns which were better than market expectations. Interest rates on new loans remained at a low level, while private credit expanded as seen in both corporate and households sectors.

Businesses continued to seek funding through both debt and equity instruments. The Thai baht depreciated from the previous quarter, in line with regional currencies, as the U.S. dollar strengthened. In addition, the depreciation was due to a seasonal factor in the second quarter during which foreign corporates and investors in Thailand repatriated their dividends back to their home countries. The real effective exchange rate (REER) strengthened because Thailand's inflation increased faster than that of trading partner economies.

Financial stability remained sound but there existed pockets of risks that warranted monitoring. These included, first, the search for yield behavior which persisted in the prolonged low interest rate environment that could lead to increased underpricing of risks. For example, concentration of investment by foreign investment funds in certain countries and large expansions of assets and deposits of saving cooperatives despite some slowdown after the revision of regulations to upgrade supervision practices. Second, volatility of international capital flows and the global financial markets could trigger yield snapbacks and affect roll-overs of short-term corporate bonds. Third, overall credit quality remained unchanged but deteriorated among some households and businesses, especially households with large debt burden and smaller SMEs with weak financial positions. Fourth, there continued to be an excess supply of properties of certain price ranges and in some areas. This was particularly the case for condominiums with prices below three million baht whose supply remained high and would take some time to sell.

3. Economic and Inflation Outlook

The Thai economy was projected to continue expanding at 4.4 and 4.2 percent in 2018 and 2019, respectively, higher than assessed at 4.1 percent for both years in the previous *Monetary Policy Report*. The upward revision was on the back of a continued improvement in merchandise exports and tourism, in tandem with global trade volume and trading partners' economies, as well as higher-than-expected private consumption and private investment growth.

Merchandise exports continued to expand across various product categories and almost all export destinations. The value of merchandise exports in 2018 was revised to grow 9.0 percent, up from 7.0 percent assessed in the previous quarter, with expected growth in both price and quantity terms. Export prices was projected to trend up in line with crude oil prices, especially for commodities and oil-related products. Export volume would continue to expand across various product categories, particularly electronics, auto parts, and processed agricultural products, in tandem with expansion in global trade volume and trading partner economies. Moreover, import value would continue to rise in line with (1) increased demand for raw materials and intermediate goods, capital goods, and machinery as private investment improved and (2) higher oil prices. Nevertheless, the Committee assessed that intensifying trade retaliation between the U.S. and major economies, which could put pressures on investment and international trade, would directly and indirectly affect Thai exports. Thus, the Committee would closely monitor and assess potential impacts going forward.

Exports of services in 2018 were expected to be slightly higher than the previous assessment due mainly to a higher number of foreign tourists. The projection of the number of foreign tourists was revised up to 38.3 million in 2018, up from the previous forecast of 37.6 million. The upward revision was due to continued growth of Chinese tourists for both tour groups and free and independent travelers (FIT), who had high purchasing power, and newly opened direct flights from second-tier Chinese cities to Thailand. In addition, recent management by airlines and airports also helped alleviate airport capacity constraints in accommodating the rising number of tourists. For instance, there were additional flights during off-peak times and higher utilization of regional airports.

Private consumption was projected to gain traction from the previous period, supported mainly by non-farm households, especially middle- and high-income households whose earnings continued to rise. Meanwhile, earnings of low-income households started to improve following stronger employment particularly in construction and services sectors. Farm income expanded on the back of higher production, while agricultural prices of certain crops that lingered at low levels would remain a major drag on farm income. Moreover, government measures—such as the social welfare card project (second phase), the community enterprise development project, and agricultural reform project—would support purchasing power going forward. However, elevated household debt would cause households to allocate part of their income for debt repayment. In addition, ongoing structural changes in the labor market would continue to weigh on private consumption growth.

Public spending remained a driver of economic growth, with some investment projects postponed to 2019. Public consumption would continue expanding despite smaller projected outlays due to the change in the government budget structure for fiscal year 2019, with a larger share of capital spending compared with the previous announcement. Although there was additional fiscal budget in 2018, this would not compensate for the moderation in public consumption due to the change in the 2019 budget structure. Public investment in 2018 was revised downward due to delayed investment by some state-owned enterprises following difficulties in accessing construction sites and some construction problems. In any case, public investment in 2019 was revised up due to the following reasons. First, a larger share of the government budget for fiscal year 2019 was allocated to capital spending compared with the previous announcement. Second, some investment spending would be carried over from 2018. Third, disbursement plans for the dual-track railway project became more certain.

Private investment was projected to achieve higher growth than previously assessed, in line with growth of merchandise exports and private consumption, due to following factors. First, capacity utilization rose across various industries, such as automobiles and food and beverages. Second, import volume of capital goods and machinery increased. Third, demand for private credits extended to businesses increased. Forth, investment plans of large corporates became more certain. Fifth, government measures such as the community enterprise development and agricultural reform projects would support low-income households. Sixth, the value of investment application submitted to the Board of Investment continued to trend up. Moreover, government infrastructure investment projects, the Eastern Economic Corridor (EEC), and public-private partnership projects (PPP) that were increasingly taking shape would shore up business confidence, foster investment climate, and attract greater foreign investment. However, developments of such investment projects would warrant monitoring going forward.

Headline inflation was projected to rise at a faster pace than the previous assessment on the back of acceleration in prices of energy-related products in tandem with global crude oil prices. However, government regulations on energy-related prices partly curbed the increase in costs of transportation and prepared food. Fresh food prices were projected to grow at lower rates following a larger-than-expected supply of meat, fruits, and vegetables. Moreover, demand-pull pressures rose only slightly due to the fact that benefits from economic growth was not yet sufficiently broad-based and that there continued to be sales promotion offered by businesses. In addition, structural changes—such as developments of production technology and higher business competition—still put downward pressures on inflation. Thus, the Committee saw the need to study the impact of such factors on inflation dynamics in further details as this could have significant implications on determining the inflation target in the future. **The Committee therefore projected headline inflation to average 1.1 and 1.2 percent in 2018 and 2019, respectively, while core inflation was projected to average 0.7 and 0.9 percent in 2018 and 2019, respectively.**

Risks to the growth projection were expected to tilt more downward than previously assessed. The increased downside risks were mainly due to external factors. First, U.S. trade protectionism measures, retaliation by major economies, and intensifying competition resulted from trade diversion could have greater-than-expected impacts on Thai exports and private investment. Second, growth of Thailand's trading partner economies might be lower than expected in case of intensifying global geopolitical tensions. Moreover, certain domestic factors also posed downside risks to the baseline projection. First, private consumption growth might be lower-than-expected as domestic purchasing power had yet to recover in a broad-based manner. Second, the enforcement of the Public Procurement and Supplies Management Act, B.E. 2560 could lead to longer-than-expected delay in budget disbursement of some government agencies. Nonetheless, on the upside, there were possibilities that the growth outturn might be higher than the baseline projection. First, growth of trading partner economies might be higher than expected given the U.S. economy continued to improve and the Chinese growth that could slow down at a slower pace than expected should the Chinese government implement additional economic stimulus measures. Second, domestic spending could be higher than the baseline assessment due to government infrastructure investment projects, public-private partnership (PPP), as well as government measures aimed at stimulating private spending. **Risks to the headline and core inflation projections were expected to tilt more downward than the previous assessment** consistent with the risks to the growth forecast.

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