Communications and Relations Office, Corporate Communications Department
Tel. +66 2283 5016-7 Fax. +66 2283 6969 www.bot.or.th

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Monetary Policy Report, September 2018

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

The Committee assessed that the Thai economy continued to gain traction but was still subject to significant risks from the U.S. trade protectionism measures and retaliatory measures by its trading partners. Headline inflation was projected to trend up, although there were downside risks with respect to highly volatile fresh food prices. Financial stability remained sound but there was a need to monitor pockets of risks that might pose further vulnerabilities to financial stability in the future. **The Committee weighted various factors in determining the most appropriate course of monetary policy and voted 6 to 1 and 5 to 2 to maintain the policy rate at 1.50 percent on meetings on August 8 and September 19, 2018 respectively.** In deliberating their decision, the Committee viewed that the current accommodative monetary policy stance remained necessary to help sustain economic growth and foster headline inflation to move within the target. Under the Committee's assessment, the policy rate at 1.50 percent would facilitate sufficiently accommodative financial conditions as reflected in the new loan rate (NLR) which remained at a low level. Despite some increases, the real policy rate and government bond yields remained accommodative overall and continued to support business financing. Meanwhile, financial stability risks remained manageable. Nonetheless, some Committee members voted to raise the policy rate by 0.25 percentage point to 1.75 percent as the economy was sufficiently robust and expanded above potential. In their view, the financial system showed signs of increased vulnerabilities at a broader scale as prolonged accommodative financial conditions led consumers and businesses to underprice risks. Thus, some members voted to raise the policy rate to curb the build-up of vulnerabilities to financial stability and also to start building up policy space for the future.

The Committee viewed that the current accommodative monetary policy stance remained necessary. Members also discussed conditions and appropriate timing to begin normalizing monetary policy in the future. Under the Committee's view, should economic expansion continue and inflation move more firmly within the target, the need for currently extra accommodative monetary policy would start to be gradually reduced, and the need for a policy rate increase in order to build up policy space in the future would be increasing. The Committee's evaluation of the appropriate conditions would be data dependent, including careful assessment of the outlook of economic growth and inflation, as well as risks especially on the external front.

<u>Assessment of the Economic and Financial Outlook as the Basis for Policy Formulation</u>

1. Global Economy

The global economy was projected to continue growing in line with the previous assessment despite a slight slowdown in 2019. Thailand's trading partner economies continued expanding in 2018. In particular, the U.S. economy recorded robust growth due to strong economic fundamentals and fiscal stimulus. Meanwhile, growth of the euro area and Asian economies slightly slowed down. Growth of trading partner economies would be lower somewhat in 2019 owing to the impact of trade protectionism measures on global trade volume, some effects of the 200 billion dollar worth of tariff that the U.S. imposed on China's exports, and tightening financial conditions in several countries. **The Committee thus maintained the growth forecast for Thailand's trading partners at 3.8 percent in 2018, while revising down the growth forecast from 3.6 to 3.5 percent in 2019.** Risks that would warrant monitoring included the U.S. trade protectionism measures which could intensify and lead to retaliatory measures. Moreover, geopolitical risks remained uncertain and could escalate to impact financial and commodity markets as well as the real sector. In addition, concerns over China's financial stability would continue to warrant monitoring despite regulatory improvements by the Chinese authorities.

Most central banks maintained accommodative monetary policy stance, while some central banks in the region raised their policy rates. The Bank of Japan was expected to keep their short- and long-term target rates on hold for some period after adjusting their forward guidance and allowing more flexibility in movements of the 10-year government bond yield. The European Central Bank would likely maintain its policy rate until the second half of 2019. Meanwhile, the U.S. Federal Reserve would continue its monetary policy normalization. The Bangko Sentral ng Pilipinas raised the policy rate to stabilize inflation, while Bank Indonesia hiked its policy rate to curb volatility in financial market. Going forward, continued economic growth and rising inflation toward target would facilitate monetary policy normalization for other central banks in the region.

Emerging markets (EMs) experienced capital outflows owing to concerns over intensifying trade protectionism measures, higher costs of financing in global financial markets due to the increases in the U.S. policy rate, and weak economic fundamentals of some EMs. As a consequence, foreign investors sold assets in vulnerable EMs such as Turkey, Argentina, and South Africa and redirected their investment toward markets with stronger external stability such as Thailand, South Korea, and Taiwan. However, global financial markets would likely remain volatile and warrant close monitoring in the period ahead.

2. Financial Conditions and Financial Stability

Thailand's financial conditions remained accommodative. Short-term Thai government bond yields increased but remained below the policy rate. Medium-term bond yields rose due to domestic factors as the latest economic outturns were better than market expectations. Meanwhile, long-term bond yields increased only slightly due to higher demand for long-term bonds particularly from foreign investors. The new loan rate remained at a low level. Private credit expanded for both business and household sectors. Businesses continued to seek funding through both debt and equity instruments. The Thai baht appreciated against the U.S. dollar from the previous quarter following better-than-expected economic outturns, greater clarity on the timeline of the upcoming general election in Thailand, and the investment of foreign investors in EMs with strong external stability. The real effective exchange rate (REER) appreciated.

Financial stability remained sound but there remained pockets of risks that warranted monitoring. These included, first, increased vulnerability in the property sector. As financial institutions competed in extending mortgage loans and became willing to bear higher risks, credit standards became looser. Furthermore, the share of non-performing loans in mortgage loans increased. Meanwhile, the oversupply of condominiums in certain areas remained high. Second, elevated household debt had yet to show clear signs of deleveraging, while debt serviceability of households and small businesses deteriorated. Third, the search-for-yield behavior persisted in the prolonged low interest rate environment which could exacerbate underpricing of risks by the private sector. For instance, saving cooperatives continued to provide high returns to members resulting in high growth of their assets, which in turn could pressure them to search for higher returns. In addition, in the prolonged low interest rate environment, the issuance of corporate bonds was concentrated among large corporations, which tended to invest more in non-core businesses and overseas enterprises. This would pose greater risks to business operations.

3. Economic and Inflation Outlook

The Thai economy was projected to record robust and continued growth at 4.4 and 4.2 percent in 2018 and 2019, respectively. The growth forecast was consistent with the assessment in the previous *Monetary Policy Report*. Key economic drivers stemmed from improvements in private spending, both through consumption and investment, thanks to a more broad-based increase in employment and support from greater clarity on public investment projects, as well as continued expansion of merchandise exports and tourism. Nonetheless, public spending growth was projected to be lower than expected.

Merchandise exports were projected to grow in line with global demand and partly benefited from the relocation of production base to Thailand for some export industries. The value of merchandise exports in 2018 was projected to expand at 9.0 percent unchanged from the previous assessment. However, export growth in 2019 was expected to slow down to 4.3 percent from the previous estimate of 5.0 percent given the assessment of some impacts of the U.S. trade protectionism measures and China's retaliatory measures on global trade volume and Thailand's trading partner economies. Meanwhile, the Committee assessed that trade protectionism measures could intensify and rapidly develop which would put pressures on international trade and investment. This would in turn affect both directly and indirectly Thailand's exports. Thus, the Committee would monitor more closely developments of trade policies and negotiations, their effects on supply chains, and impacts on Thai businesses.

Exports of services in 2019 were expected to rise because some Chinese tourists postponed their travel plans from the latter half of 2018 following the Phuket tour boat sinking incident in early July. The projected number of foreign tourists in 2018 was kept at 38.3 million unchanged from the previous assessment due to a higher-than-expected outturn in the second quarter, which offset a drop in the number of Chinese tourists during the second half of 2018. The impact of the Phuket boat incident, nonetheless, was expected to be short-lived given signs of recovery in Chinese tourist figures in many areas. For 2019, the projected number of foreign tourists was revised up from previously assessed to 40.6 million due to postponed travel plans by some Chinese tourists from 2018, new flight routes, and greater airport capacity following increased management efficiency.

Private consumption was expected to achieve higher growth supported by improvements in household income. Medium- and high-income households in the non-agricultural sector experienced steady income growth. Low-income households also experienced income growth supported by improvements in employment in most sectors. Meanwhile, farm income expanded on the back of higher agricultural production and support from government policies. However, elevated household debt would cause households to allocate part of their income for debt repayment. Moreover, structural changes in the labor market such as adoption of automation in place of human labor in the production process limited wage increases. As a result, purchasing power would recover gradually.

The government would help drive the economy despite some slowdown in public spending compared with the previous assessment. Government consumption expenditure, particularly compensation of civil servants with regard to salary and medical expenditure, was projected to decrease given the policy to replace vacant job positions with contract workers. Public investment decreased for both the central government and state-owned enterprises. For the central government, investment were revised down due to lower efficiency in budget disbursement by some government units, following construction problems that included limited construction capacity, land reclamation issues, and larger-than-expected impacts of the Public Procurement and Supplies Management Act, B.E. 2560. For state-owned enterprises, some investment projects faced operational difficulties including project revisions, funding reviews, and bidding process delays.

Private investment was projected to gain traction with further improvement in 2019 thanks to better-than-expected private consumption, together with capital outlays following production relocation to Thailand of some export-oriented industries during late 2018 and 2019. Moreover, other supporting factors included (1) higher capacity utilization in various industries such as automobiles, electronics, and chemical products, (2) greater clarity on investment plans of large companies, (3) higher demand for corporate credits, and (4) improved investment sentiment following greater clarity on infrastructure investment projects, the Eastern Economic Corridor (EEC), and public-private partnership (PPP).

The outlook for inflation in 2019 was expected to rise in line with the previous assessment. Price increases in the fresh food items was projected to be slower than expected mainly because supplies of meat, vegetables, and fruits were expected to increase more than previously assessed due to favorable weather conditions, the government's irrigation management that gave priority to agricultural purposes, and advancement in agricultural technology. Meanwhile, energy prices rose in tandem with global crude oil prices. Demand-pull inflationary pressures lowered partly due to structural factors including improvement in production technology that resulted in lower costs of goods and services, expansion of e-commerce, and globalization that led to intense competition and difficulty in raising prices. Such factors could result in more persistent inflation than in the past, although the economy expanded in line with its potential. **The Committee therefore projected headline inflation to average at 1.1 percent in 2018 and 2019 and core inflation to average at 0.7 and 0.8 percent in 2018 and 2019, respectively.**

Risks to the growth projection were expected to tilt downward but with a smaller degree than the previous assessment due to an increased possibility that the Thai economy would outperform the baseline projection supported by (1) domestic demand growth that could be higher than expected thanks to infrastructure investment and government stimulus measures to support private spending that could be additionally announced, (2) growth of Thailand's trading partner economies that could be higher than expected on account of continued improvements in the U.S. economy with support from tax reforms, (3) a Chinese economic slowdown that could be less severe than expected if the Chinese government were to announce additional stimulus measures, which would eventually lead to better-than-expected Asian exports, and (4) the number of Chinese tourists that could be larger than expected following the recovery after the Phuket boat incident. However, there remained possibility that the Thai economy would grow at a rate below the baseline projection despite the baseline projection already taking into account some impact of the 200 billion dollar worth of tariff that the U.S. imposed on China's exports. Such possibility is due to uncertainties regarding (1) the U.S. trade protectionism measures and additional retaliatory measures from major economies as well as intensifying competition resulted from trade diversion which could weigh on Thailand's exports and investment, (2) Thailand's trading partner economies which could expand at lower rates than expected due to tensions arising from geopolitical risks and economic problems among EMs, (3) domestic purchasing power that improved only gradually could affect private consumption growth, and (4) the Public Procurement and Supplies Management Act which could delay budget disbursements for some government agencies as well as public investment projects by state-owned transportation enterprises which might experience delays due to reviews of investment project approvals. **Meanwhile, risks to the forecasts of headline and core inflation were expected to tilt downward** in line with risks to the growth projections and highly volatile fresh food prices.

Bank of Thailand
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For further information: Monetary Policy Strategy Division
Tel. 0 2283 6186, 0 2356 7872
E-mail: MPStrategyDiv@bot.or.th