Minutes of the Monetary Policy Meeting of the Monetary Policy Committee

Bank of Thailand

30 November 2011

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Members Present

Prasarn Trairatvorakul (Chairman and Governor), Suchada Kirakul (Vice Chairman and Deputy Governor, Monetary Stability), Sorasit Soontornkes (Deputy Governor, Corporate Support Services), Ampon Kittiampon, Siri Ganjarerndee, Narongchai Akrasanee, and Aswin Kongsiri.

Financial Markets

The euro area's sovereign debt problem persisted and had increasing ramifications on financial markets. Funding costs for both government and private sectors rose noticeably. Credit Default Swap (CDS) premia increased for euro area countries such as Italy and Greece as well as for some Asian economies. Interest rates in the US dollar and euro interbank markets also rose, reflecting further decline in investors' confidence. As investors curtailed their holdings of risky assets, equity markets became more volatile and the Thai baht, along with regional currencies, depreciated against major currencies such as the US dollar and the Japanese yen.

The floods had only a temporary and limited impact on the Thai financial market. While demand for cash increased notably during the crisis, transaction volume in the interbank and foreign exchange markets decreased slightly. Both cash demand and financial market activities have now returned to their normal levels. The significant impact of the floods on the real economy led most market participants to anticipate that the MPC would reduce the policy rate at this meeting.

The International Economy

Downside risks to the global economy increased as the impact of the euro area's sovereign debt problem on the major economies became more apparent. The probability of the euro area falling into a recession increased markedly given sharp declines in industrial production and consumer confidence. **The US economy** showed signs of a stronger recovery, particularly with respect to production and consumption indicators. Nevertheless, output growth would remain below potential as weaknesses in labor and housing markets continued to weigh on the economy. In addition, US financial markets remained susceptible to spillover effects from problems in the euro area. **Economic growth in Asia** softened as export growth moderated on the back of global economic slowdown. Meanwhile, persistent inflationary pressure in the region started to level off as global commodity prices moderated. Most countries therefore decided to keep policy rates on hold, pending clearer assessment of the repercussions from the global economic slowdown.

Members were concerned about the euro area's problem especially on the sustainability of the currency union and the economic costs involved in the periods ahead. They also viewed that the lack of confidence in the euro currency and financial conditions of euro area banks may pose risks to the Thai financial sector and the overall economy, especially through indirect channels emanating from the wide ranging business scope of euro area banks. The MPC thus stressed the need to closely monitor the situation.

The Domestic Economy

The impact of the floods on the Thai economy was greater than previously anticipated. Apart from the direct impact on agriculture and manufacturing production in areas that were inundated, there was significant indirect impact through supply chain disruptions especially in the automobile, electronics, and electrical appliances sectors. Private sector confidence declined substantially. The MPC revised up its assessment of the economic damage of the floods from 1.1 percent to 2.1 percent of GDP and lowered its growth projection for 2011 from 2.6 percent in the last meeting to 1.8 percent.

Despite the severity of the floods, the MPC expected a reasonably swift recovery. Most economic activities were expected to return to normal by mid-2012, a time frame that is consistent with government restoration measures exerting their full impact and in line with survey results indicating that a majority of firms expected full resumption of production within six months. Overall, economic growth is projected to stand at 4.8 percent in 2012.

The MPC stressed the importance of the ability of the private sector to obtain adequate financing for restoration purposes. For firms that will be compensated with insurance payouts, there was concern whether they could obtain necessary financing in the interim before those payouts are received given the potentially long delays involved in damage assessments. The MPC expected financial institutions to provide relatively low-risk bridge loans to such firms to support a smooth recovery of the economy.

Inflationary pressure continued to be sustained by the anticipated pickup in private sector demand associated with post-flood restoration spending as well as from government stimulus measures, including an increase in the budget deficit, increase in minimum wage, and the rice mortgage program. However, the slowdown of commodity prices in line with the global economy would help to mitigate inflationary pressure to some extent. Meanwhile, price increases driven by flood-related shortages, such as in vegetables and fruits, are expected to be temporary and only limited to certain areas. In addition, government administrative measures and relatively stable inflation expectations would help contain the risk of inflation accelerating to a level that would threaten economic stability.

Monetary Policy Considerations

The MPC assessed that the risk of a global economic slowdown has increased from the previous meeting while upside risks to inflation remained limited. Although the flooding has eased and the economy has already moved onto the restoration phase, private sector confidence remained weak. **In this context, monetary policy could play a greater role in**

supporting economic recovery, especially by facilitating investment to restore productive capacity, without compromising the primary goal of maintaining economic stability. The MPC thus agreed to reduce the policy rate in this meeting. Nonetheless, members differed in their assessment of the degree of policy accommodation needed.

Two members deemed that a reduction of the policy rate by 0.5 percent per annum was appropriate given the high risk of a further weakening of the global economy stemming from the protracted debt problem in the euro area that is more serious than previously assessed, as well as the limited policy room for further stimulus measures among G3 economies. At the same time, the impact of flooding on the Thai economy was much more severe than previously projected. Given that upside inflation risks appeared to be contained, in part due to the moderation in commodity prices from a slower world economy, monetary policy should be eased substantially in order to frontload the stimulus provided to support economic recovery. The reduction in funding costs for small and medium enterprises (SMEs) and households that need credit during this time was viewed as especially important in facilitating the restoration process.

Five members decided to reduce the policy rate by 0.25 percent per annum based on their judgment that the current monetary policy stance was already accommodative and that private sector spending, supported by strong financial institutions and government stimulus measures, would generate sufficient recovery momentum. Therefore, the reduction in the policy rate should be commensurate with the needs of the economy without posing additional risks to economic stability. In this respect, a more measured policy rate reduction was seen as conducive to bolstering confidence while limiting the potential for undue volatility in the exchange rate that may hamper private investment through their impact on import costs. Moreover, should conditions change materially, monetary policy could be adjusted as warranted. Some members viewed that in shoring up private sector confidence and alleviating constraints on SMEs, a reduction in the policy rate constituted only one contributing factor. More importantly, confidence would hinge on the government's ability to implement a credible plan to resolve the flood-related structural problems to prevent the recurrence of the crisis, whereas the underlying challenge for SMEs lay in the difficulties in obtain financing rather than the cost of funds.

The MPC therefore voted 5 to 2 to reduce the policy rate by 0.25 percent, from 3.50 percent to 3.25 percent per annum. The MPC would remain vigilant in monitoring developments in the global economy as well as progress on domestic restoration efforts and stands ready to take appropriate policy actions.

Monetary Policy Group

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