Minutes of the Monetary Policy Meeting of the Monetary Policy Committee

Bank of Thailand

1 June 2011

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Members Present

Prasarn Trairatvorakul (Chairman and Governor), Atchana Waiquamdee (Vice Chairman and Deputy Governor, Monetary Stability), Suchada Kirakul (Deputy Governor, Corporate Support Services), Ampon Kittiampon, Praipol Koomsup, Siri Ganjarerndee, Krirk-krai Jirapaet.

Financial Markets

Transmission from the policy rate to commercial bank rates continued to be effective. Many commercial banks raised both lending and deposit rates following the policy rate hike from the previous MPC meeting (20 April 2011). In addition, commercial bank rates have responded well in the past during both upward and downward interest rate cycles. **Regarding interest rate expectations prior to this meeting,** short-term money market rates and a rise in the short-end of the government yield curve showed that the market had priced in a policy rate hike. This was consistent with survey results in which all market participants forecasted a rate hike of 0.25 percentage points.

Increased risk in global financial markets from sovereign debt problems in the euro area contributed to a decrease in foreign investment in the Thai equity and bond markets. This pattern was similarly observed in regional financial markets. **The baht and the majority of other regional currencies depreciated relative to the US dollar** as investors increased holdings of US dollar assets amid higher risk in global financial markets. **The euro** depreciated in line with lower market expectations of an increase in rate differential after the ECB signaled its intention to slow the pace of tightening. **The Japanese yen** weakened after prior strengthening due to announcements that GDP in the first quarter had contracted more than previously expected from the earthquake.

Growth in the International Economy and the Domestic Economy

The global economy slowed somewhat in the first quarter but was expected to maintain the growth momentum in the second half of the year. The US economy began to show signs of a slowdown in consumption growth as a result of increased inflation. The Japanese economy contracted in the first quarter of 2011 as a result of the natural disaster but was expected to resume expansion in the second half of the year due to (1) disbursement of government spending starting at the end of the second quarter, (2) reconstruction of damaged factories and (3) resolution of supply shortage largely by the third quarter. The euro area economy would continue to expand on the back of growth in core member countries, such as Germany and France, but risks from sovereign debt problems remained from periphery member countries especially Greece, which failed to lower its fiscal deficit as planned. Some members noted that sovereign debt problems have yet to impact growth in core member countries. Meanwhile, the Asian economy expanded robustly due to both external and internal demand.

The Thai economy expanded well in the first quarter of this year. Private investment, exports and agricultural production expanded more than expected despite the clearly discernable impact of the Japan crisis on manufacturing production in the second quarter. Latest data showed that production would recover rapidly in the second half of the year. In particular, the automobiles sector would recover faster than other countries in the region, as Thailand serves as a production and export base and therefore was one of the first to receive automobile parts from Japan. As a result, manufacturing would return to normal levels without compromising export targets for the entire year. In addition, the electronics sector was not affected by the supply disruption, due to availability of parts from alternative sources, and would continue to expand. Going forward, the Thai economy's growth momentum should be sustained by robust farm income, strong employment conditions and supportive credit growth.

Inflation in the Global Economy and Domestic Economy

Inflationary pressure increased in many regions in line with high oil and commodity prices. Oil and commodity prices remained elevated despite prospects of some slowdown in the future. As a result, inflation would continue to increase in many regions, especially in Asia where tight labor markets and closing output gaps magnify the risk of second-round inflation. In contrast, accelerating inflation in the US and euro area would probably not give rise to significant second-round inflation given the degree of slack in these economies. Nevertheless, rising inflationary pressure prompted many countries, especially those in Asia, to pursue tighter monetary policy to anchor inflation expectations.

Inflationary pressure in the Thai economy increased more than expected primarily due to upward adjustments in the prices of processed foods on the back of simultaneous increase in costs across many categories of raw foods. The price of raw foods rose partly due to the surge in global food price amid global structural change from expanded population and income. Some members noted that the aforementioned linkages partly arose because exports to global markets resulted in less supply for domestic markets, thereby driving up domestic raw food price pressure. Going forward, processed food price hikes may persist as certain firms have yet to adjust prices.

Although food price increases have yet to result in significant rises in overall prices**, robust domestic demand may lead to greater pass-through of production costs to overall prices.** As a result, core inflation may breach the upper end of the target band earlier than expected in the third and fourth quarters of this year.

Monetary Policy Considerations

Members emphasized rising inflationary pressure as a result of upward adjustments in processed food prices linked to high costs and robust economic expansion in assessing the balance of risks to growth and inflation.

Members assessed that the Japan crisis would have limited impact on the growth of the Thai economy. As a result, the growth momentum of the Thai economy would remain. Meanwhile, inflation risk rose, as reflected in greater-than-expected price pressure in the processed foods category on the back of rising costs. Inflation expectations continued to increase amid elevated oil and commodity prices.

Some members observed that risks to economic expansion stemmed from the possibility that the global recovery may prove to be slower than expected. The US economy posted lower growth than expected in the first quarter. In addition, sovereign debt problems in the euro area remained a key risk to the economy. Lastly, the domestic political situation post-election may have implications on both growth and inflation going forward. However, those members judged that **risks to inflation outweighed the risks to growth.**

Members assessed that robust domestic demand may lead to greater pass-through of production costs to overall prices. As a result, there is a risk that inflation may accelerate and persist. In the baseline scenario, core inflation was projected to breach the upper end of the target band in the next two quarters before returning within the band under the assumptions that (1) oil and commodity prices would not surge again and (2) policy rate normalization would continue in the period ahead. Members discussed the need to raise the policy rate by more than 0.25 percentage points but concluded that a rate hike of 0.25 percentage points would be more appropriate given that financial markets and the economy have thus far responded well in the desired manner to gradual rate hikes, risks to growth in the G3 economies have yet to be fully resolved, and the political situation post-election remains uncertain.

The MPC therefore decided unanimously to raise the policy interest rate by 0.25 percentage points, from 2.75 to 3.00 per cent per annum, effective immediately. The MPC also emphasized that inflationary pressure needs to be closely monitored going forward so that appropriate policy action can be taken promptly when required.

Monetary Policy Group

15 June 2011