Minutes of the Monetary Policy Meeting of the Monetary Policy Committee

Bank of Thailand

13 July 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. Commercial banks raised interest rates immediately following the policy rate hike from the previous MPC meeting (1 June 2011). **Regarding interest rate expectations prior to this meeting,** continued increases in short-term money market rates and the short-end of the government yield curve showed that the market had already priced in a policy rate hike. This was consistent with survey results in which all market participants forecast a rate hike of 0.25 percentage points.

The baht depreciated relative to the US dollar in June due to foreign investors decreasing their investments in the Thai equity and bond markets as **risk in global financial markets rose** from concerns over sovereign debt problems in the euro area, increased uncertainty over the US recovery, and **a wait-and-see attitude of investors pending the election results**. Nevertheless, **the baht appreciated after the election concluded smoothly** and market concerns over the sovereign debt problem in Greece lessened. The movement of the baht was consistent with that of most regional currencies in the same period. **The euro** depreciated amid concerns over sovereign debt that posed a key risk to financial markets.

The International Economy

Advanced economies (G3) expanded more slowly than expected in the first half of the year but were expected to retain their momentum in the latter half of the year despite some uncertainty. The US economy continued to experience structural problems in the labor and real estate markets. However, the surge in oil prices which impaired consumers' purchasing power and the supply disruption in the automobile sector stemming from natural disaster in Japan were expected to abate in the second half of the year. In addition, expansionary fiscal and monetary policies would support economic recovery of the US in the periods ahead. **The Japanese economy** recovered faster than expected due to production and domestic consumption. **The euro area** continued to expand on the back of growth in core member countries, especially Germany, but sovereign debt problems remained a key risk to financial market confidence, euro area expansion, and global economic growth. Some MPC members viewed that solving the euro area sovereign debt problems would prove to be challenging; planned privatization as well as debt restructuring and roll-over will be difficult to implement. As a result, the current lending program for Greece by advanced countries may only serve to delay eventual and necessary correction. In addition, some members noted that the euro area sovereign debt problems have yet to show any discernible impact on the real economy that may eventually spill over into Thailand's economy and exports. Meanwhile, the Asian economy expanded robustly from both domestic and external demand.

Risks to inflation remained elevated especially in Asia. Although headline inflation began to decelerate, price pressure continued to rise as reflected in the increase in core inflation and inflation forecasts that exceeded the target for many countries. Consequently, many countries continued to hike policy rates to contain inflation which may moderate Asia's economic growth going forward.

The Domestic Economy

The Thai economy expanded in the second quarter of this year from domestic demand, supported by favorable farm income and employment conditions. Manufacturing production slowed from the previous quarter due to supply disruption in vehicle parts that subsequently led to a decline in the exports of automobiles and automobile parts. Nonetheless, overall exports continued its strong growth. The supply disruption problem was quickly resolved as anticipated in the previous MPC meeting. Manufacturing and exports were therefore expected to rebound in the second half of the year. Going forward, demand was expected to be robust from (1) an upward trend in domestic and foreign purchase orders, (2) continued expansion in planned private investment, (3) favorable credit conditions especially from lending by government-owned specialized financial institutions and (4) augmented fiscal spending after the formation of a new government.

Despite a slowdown in the rise of prepared food costs, **continued upward adjustments in the prices of prepared foods together with high energy prices resulted in inflationary pressure remaining at an elevated level.** The government's extension of cost-of-living alleviation measures may slow the rise of measured inflation but once the measures expire, inflation may accelerate. In addition, the economic policy of the new government, such as the minimum wage increase, will add to inflationary pressure. Although the minimum wage bill is relatively small compared to total costs of businesses, increasing the minimum wage at a rate greater than productivity growth under strong economic expansion may result in greater pass-through to average wage and overall prices, thus adversely affecting business outlook and inflation expectations.

Many members viewed that the real minimum wage in recent history had not changed significantly. **Increasing the nominal minimum wage to levels commensurate with the rising cost of living would therefore be appropriate. However, an abrupt one-time increase in the minimum wage nationwide at a rate faster than labor productivity growth would be a challenge in view of the burden of adjustment imposed on the business sector.** The MPC assessed that there is considerable uncertainty over the potential additional fiscal spending, particularly in 2012. However, fiscal prudence would require that the government should (1) gradually phase in its spending over time; (2) prioritize its projects; (3) target those with the greatest needs; and (4) place emphasis on investment to improve productive capacity that would ensure a sustainable increase in growth and standard of living. Simultaneously, tax reform should be implemented to increase government revenue in line with rising expenditure.

Monetary Policy Considerations

Members viewed the increased price pressure from higher prepared food and oil prices amid strong economic growth and continued fiscal stimulus to be the key factor in assessing the risks to growth and inflation and the monetary policy decision.

Members assessed that the global economy still retained its growth momentum. The stabilization of oil prices at high levels and sovereign debt problems in the euro area continued to be key risks in the second half of the year. The Thai economy expanded from both domestic and external demand. **Price pressure remained a key risk** due to continued increase in prepared food and energy prices and a narrowing output gap which may result in persistently greater pass-through from production costs to inflation. The extension of the cost-of-living alleviation measures may slow the rise in measured inflation figures but other measures such as the prospective increases in the minimum wage and fiscal spending amid continued economic growth will likely add to inflationary pressure and may heighten inflation expectations.

Members discussed the risks to the Thai economy going forward such as spillovers from the Greek debt problem to other euro area economies and the uncertain US economic outlook. **Upon evaluation, members judged that the risks to inflation outweighed the risks to growth** especially in light of continued fiscal stimulus which may add to inflationary pressure. As a result, a continued increase in the policy rate would be needed to contain inflation, particularly as it is demand-driven. Nevertheless, given the global economy's current sensitivity to various risk factors and fiscal policy uncertainty due to the change in government, the MPC decided not to alter the pace of policy rate adjustments and would closely monitor the global economic recovery, progress in resolving the euro area sovereign debt problems, and fiscal policy formulation of the new government.

The MPC therefore decided unanimously to raise the policy interest rate by 0.25 percentage points, from 3.00 to 3.25 per cent per annum, effective immediately to maintain economic stability and anchor inflation expectations.

Monetary Policy Group

27 July 2011