Edited Minutes of the Monetary Policy Committee Meeting

Bank of Thailand

28-29 May 2013

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Members Present

Prasarn Trairatvorakul (Chairman), Pongpen Ruengvirayudh (Vice Chairman), Tongurai Limpiti, Ampon Kittiampon, Siri Ganjarerndee, Narongchai Akrasanee, and Aswin Kongsiri.

The Financial Markets

The US dollar appreciated against most major and regional currencies following continued recovery in the US economy, particularly in the labour market, and market anticipation that the Federal Reserve (Fed) could wind down its quantitative easing (QE) sooner than previously assessed. Thai baht depreciated slightly since the last meeting. After strengthening in early April on account of capital inflows into Thai bond and equity markets, the baht subsequently corrected, driven by market concerns over potential capital flow management measures and US dollar strength.

Government bond yields edged lower across the curve thanks to increased demand from foreign investors, particularly in early April, as well as market's expectation of a policy interest rate cut leading up to this meeting. The expected cut in policy interest rate was attributed to (1) the global economy's continued weakness and a delayed recovery, which could weigh on Thai exports going forward; (2) lower-than-expected Thai economic growth in the first quarter of this year, and (3) low inflationary pressure.

The MPC discussed capital flow developments in the regional bond markets. The committee noted a recent surge of bond inflows into Malaysia especially in the first two weeks of May, while there were net bond outflows from the Thai market. This was partly attributable to a resumption of capital inflows into Malaysia following a general election on 5 May. One member cited the larger size of the Malaysian bond market compared to Thailand, as one factor explaining the former market's better absorptive capacity, which helped stabilize the Malaysian Ringgit movements.

The International Economy

The overall global economic growth moderated from the previous meeting, with the first-quarter outturns weaker than expected in many cases. However, the outlook for

global growth points towards a gradual recovery, in line with the MPC's previous assessment. The US economy has shown signs of gradual improvement with private consumption being the main growth driver, while downside risks remain from income tax increases and automatic cuts in government spending. **The Japanese economy** expanded more than expected in the first quarter of this year, spurred by private consumption, which has begun to benefit from economic stimulus policies. Exports improved in tandem with firmer demand, particularly from the US. However, low private investment and wages pose risks to economic recovery. **The euro area economies** remained mired in recession, due to deep structural problems. Core member economies, particularly Germany, grew less than expected from moderating private consumption, while France, Italy, and Spain continued to contract. **The Chinese and Asian economies** expanded less than previously assessed. Growth in China, Taiwan, South Korea, and Hong Kong softened from tepid domestic demand. Meanwhile ASEAN economies moderated from weakening exports, linked in part to China's slowdown. Continued robust domestic demand should help sustain growth momentum in ASEAN, however. Global inflationary pressure remained subdued.

Many central banks in the region have lowered policy interest rates since the last meeting, in response to moderation in domestic demand.

In their discussion, the MPC noted that (1) it was premature to judge Japanese economic stimulus policies a success in lifting growth and inflation, as inflation remained very low and structural reforms would take time to take effect. Assessing the wealth effects of Bank of Japan's asset purchase program (Q-squared) is also a difficult task. The MPC noted that, in contrast to its main objective of lower bond yields, Q-squared measure may have played a part in pushing long-term yields higher, through raising inflation expectations. Despite this policy dilemma, the benefits from yen depreciation and improved market sentiment should also be acknowledged; (2) Q-squared measure may not be a major driver of a recent surge in capital inflows into Thailand, as the Japanese institutional investors allocated their funds mainly towards more liquid, investment-graded assets in advanced economies, such as the US and the Euro area, as well as domestic equity markets; (3) the fact that global inflation has remained subdued despite ultra-loose monetary policy in advanced economies, may be explained in part by the success of inflation targeting regime and central bank independence in anchoring inflation expectations and containing inflationary pressure; and (4) the low and stable global inflation over different phases of business cycles since the adoption of inflation targeting regime by many central banks in 2000 onwards, has made inflation a less reliable indicator of business cycles and economic imbalances. For this reason, financial indicators, such as credit growth and real estate prices, should be taken into account in assessing potential imbalances and signs of overheating. Persistently high credit growth and a rapid climb in real estate prices could lead to a build-up of financial imbalances, despite low inflation.

The Thai Economy

The Thai economy expanded lower than expected at 5.3 percent in the first quarter compared to the same period last year, from tepid domestic demand. Private consumption moderated owing in part to lower farm income, and higher household debts which may have held back consumers' willingness to spend. Private investment softened, as slower-than-expected global economic recovery led to higher spare capacity in export-oriented industries, thus postponing planned investment. Support from government spending was temporarily delayed by local government's budget disbursement. Exports continued to recover gradually, while core and headline inflation moderated owing to cost factors. Nonetheless, a structural change related to oil and gas consumption pattern following government's policy to cease production and sales of benzene 91 in January 2013 contributed to a larger-than-expected drop in private consumption. The committee has taken this special factor into account in assessing the outlook for economic momentum.

Looking ahead, the economy should continue to expand on the back of solid economic fundamentals including high levels of employment and non-farm income, as well as robust private sector confidence, which should lead to stronger private consumption in the latter half of the year. Private investment should pick up as the global economy recovers as expected. Effects of central government's spending on domestic demand are also expected to become more evident. Nevertheless, **as a result of weaker-than-expected economic outturns in the first quarter, growth projection for 2013 has been revised downward from the last meeting**. Inflationary pressures eased further compared to the previous projection in tandem with downward trend in oil prices, but the cost pass-through to prices is expected to increase as domestic demand recovers.

One member saw a need to monitor an ongoing structural adjustment of the Thai economy as follows: (1) a tightening in labour market has accelerated a substitution of labour by new machinery. Thus a measure of capacity utilisation that includes redundant older capital stock may be overstating the real supply capacity of the economy; and (2) the tourism and service sectors continued to expand robustly, and may develop to become a main driver of growth, in place of the export sector. Another member inquired if factors could be identified as key to generating income for the economy going forward. Staff cited strong underlying economic fundamentals, robust demand for loans, and the labour market flexibility which helped channel workers away from agriculture in periods of falling farm income. In addition, exporters have become more resilient to baht movements thanks to their continued adjustment.

Financial stability warranted close monitoring, as household debts continued to grow at a high pace, driven by consumer loans. An accumulation of household debts could potentially weigh on private consumption and overall growth, as well as increase households' vulnerability to negative income shocks. Members largely agreed on the following: (1) overall financial statements of households may mask different types of underlying collaterals, which might affect the economy with varying degrees; (2) the informal segment of household debts, which is sizeable, warranted further research and closer monitoring. The real estate market continued to gain pace, partly attributable to a structural change in real demand. However, an increase in number of second and higher home mortgages pointed to speculative demand in certain areas.

Monetary Policy Deliberation

The MPC judged that the Thai economy should continue to expand on the back of sound economic fundamentals, although downside risks have increased from lower-than-expected growth in the first quarter of this year. Inflation remained well within the target range. **With the balance of risks tilting towards growth rather than inflation, the MPC saw further room to ease monetary policy and cushion the economy against downside risks to growth.**

Key conclusions reached during policy discussion were as follows:

(1) The global economic recovery was slower than expected. In particular, the Chinese and Asian economies expanded less than expected and may adversely affect Thai exports' recovery. Global financial market remained volatile, leading to persistent capital flows into the region including Thailand, and high baht volatility.

(2) The Thai economy in the first quarter of 2013 grew less than expected mainly due to moderating private consumption and investment, together with a delay in fiscal support, which could weigh on economic momentum in the periods ahead. Some MPC members saw a need to closely monitor developments of public investment in large-scale infrastructure projects, as well as private investment as there could be further delay.

(3) Inflationary pressure has declined since the previous meeting, from lower oil and commodity prices, in line with softening global economic outlook.

(4) Risks to financial stability remained a concern, with high growth of private credit and household debts potentially affecting private consumption and overall growth in the periods ahead. Buoyant activities in real estate market may have been partially driven by speculation.

One member viewed that the Thai economy still faced risks from capital flows due to interest rate differential which might cause exchange rate volatility. Some members noted that given ongoing concerns about financial stability and capital flow volatility, complementary policy measures including capital flow management and macro-prudential measures could be considered alongside policy interest rate as needed.

The MPC thus voted unanimously to reduce the policy rate by 0.25 percent from 2.75 to 2.50 percent per annum. The MPC will closely monitor developments of the Thai economy, financial stability risks as well as capital flow situation, and stand ready to take appropriate policy action as warranted.

Monetary Policy Group
12 June 2013