Edited Minutes of the Monetary Policy Committee Meeting

Bank of Thailand

20 February 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 global financial market sentiment improved thanks to better-than-expected economic releases from the US and China. Nonetheless, political uncertainties in parts of the Euro area and concerns that central banks in the region might introduce measures to rein in excessive exchange rate volatility led to more subdued capital inflows into regional bond and equity markets, and corresponding depreciation of regional currencies toward the end of January. The pace of baht appreciation also decelerated in tandem.

Short-term money market rates remained stable and close to the policy interest rate. Government bond yields edged lower across the curve following increased demand from both domestic and foreign investors, and markets pricing in a possibility of policy interest rate cut. Nonetheless, most market participants expected that the MPC would maintain the policy interest rate at this meeting.

The International Economy

The global economy has been more stable and showed signs of improvement since the previous meeting. In the US economy, there were some improvements in the labour and housing markets. Private consumption and investment continued to expand and, if sustained, should play a significant role in supporting the economic recovery. However, the US economy remained subject to downside risks from uncertainties regarding the fiscal consolidation. **The Japanese economy** has yet to gain traction but exhibited incipient signs of recovery in manufacturing sector and private investment. Monetary and fiscal stimulus policies, especially through public investment, should help support the economic growth going forward. **The Chinese and Asian economies** have expanded well on the back of strong domestic demand and improving prospects of exports, together with further support from Japanese government stimulus measures. **The eurozone economies** remained weak and continued to be in recession. Better economic confidence and financial market sentiment have not had a clear impact on lifting the real economy, while sovereign debt crisis would take time to resolve.

Some MPC members saw no new evidence to suggest that structural problems in the eurozone and Japanese economies could be resolved sooner than previously assessed. In some members' views, the global financial market sentiment remained fragile and would not lend a significant boost to the real economic recovery. Emerging markets, some members noted, would play an increasingly important role in the global economic and financial systems, which would bring a number of new challenges, including those related to capital movements.

The Thai Economy

The Thai economy expanded more than expected in the fourth quarter and for the whole of 2012. Government and private consumption were the main growth drivers, supported by strong underlying economic fundamentals as well as accommodative fiscal and monetary policies. Exports has gradually recovered in line with more stable global economic outlook and expanding manufacturing production. Core inflation remained stable, without evident pass-through effect from a minimum wage hike.

The MPC agreed that the economy would continue to expand, and discussed potential risk factors that might undermine growth momentum going forward, including labour shortages, risks to financial stability in some sectors and sustainability of the tourism industry.

Financial stability overall warranted close monitoring with key risks stemming from;

(1) The ongoing high credit growth, particularly for consumer credits, as well as a surge in household debts which have had some effects on households' debt servicing abilities. A number of studies and experiences from other countries suggested that a prolonged period of low interest rates could lead to a build-up of financial imbalances in the economy. In addition, a pre-condition for macroprudential tools to be effective, is that the policy interest rate is first set at an appropriate level for maintaining macroeconomic stability;

(2) The adverse economic impact of capital inflows and exchange rate volatility. However, various studies found that interest rate differential was a less important determinant of capital inflows when compared to other factors such as investors' assessment of the economic outlook and expectations of future currency movements and;

(3) Rises in some asset prices which, if continued, can potentially develop into bubbles. In the relatively low interest rate environment, investors can be induced to search for higher returns as well as speculate in riskier assets, especially in real estate and equity markets.

The MPC therefore deemed it necessary to closely monitor development of these risks and, if warranted, will implement an appropriate policy mix to guard against potential imbalances in the economy going forward.

Looking ahead, the Thai economy is projected to expand on the back of strong domestic demand, particularly from private investment, owing in part to greater machinisation to replace labour which has become more expensive and scarcer. Exports should also gradually recover and contribute more to growth in the latter half of the year. **As a result, growth projection was revised upward from the previous assessment**. Inflationary pressure has risen slightly in line with improving economic outlook and an increase in oil prices.

<u>Monetary Policy Considerations</u>

The MPC agreed that uncertainties surrounding the global economic outlook remained, while the Thai economy continued to expand on the back of strong domestic demand. Capital inflows were expected to continue, while risks to financial stability warranted close monitoring.

Six members viewed maintaining the policy rate at 2.75 percent per annum as justified, given that: (1) despite improving overall global economy, the global economic recovery is still subject to downside risks, from the lingering euro debt crisis and uncertainty regarding the US fiscal consolidation, (2) the Thai economy continued to expand robustly, spurred by the strong domestic demand, which should help sustain growth momentum going forward. However, one member noted that it was necessary to closely monitor the developments of the Thai economy after some indicators of economic activity moderated in December 2012, and (3) risks to financial stability remained, including from rising asset prices and the high pace of credit growth, especially for household credits. Policy rate should therefore be kept unchanged, until there is a greater clarity on the overall risks to the economy. One member noted that interest rate differential played a part in affecting capital inflows, though the strength of this relationship varies over different phases of the business cycles and with financial market sentiments. With a systematic and appropriate approach for managing capital flows in place, the same member deemed maintaining the policy rate as justified. Other complementary measures could also be considered as needed.

One member deemed a reduction of the policy rate by 0.25 percent per annum as appropriate on the basis that, despite signs of stabilisation, risks to the global economic outlook particularly for Asian economies remained. This was evidenced by the downward revision to 2013 global growth projections released by the International Monetary Fund and the World Bank in January 2013, relative to their previous publications. Moreover, a recent surge of capital inflows has been larger than in the past, which could cause larger adverse impact on the Thai economy than previously assessed. In addition, the low interest rate environment was not the only factor driving credit growth, rising household debt or asset prices. Macroprudential measures should also be used to counter any build-up of financial imbalances. Against this backdrop, a policy rate reduction would help mitigate risks of capital inflows and still fragile economic momentum, and would send a public signal about the MPC's concerns on these issues.

The MPC therefore voted 6 to 1 to maintain the policy rate at 2.75 percent per annum. Going forward, the MPC will continue to closely monitor risks to financial stability and capital flow situation, and stand ready to take appropriate policy actions as warranted.

Monetary Policy Group

6 March 2013