Edited Minutes of the Monetary Policy Committee Meeting

Bank of Thailand

23 April 2014

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Members Present

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

The Financial Markets

Uncertainties regarding the timing of policy rate hike by Federal Reserve were the main drivers of exchange rates and government bond yields since the last MPC meeting. The Thai baht depreciated toward the end of March, following the Federal Open Market Committee (FOMC)'s press conference which shifted forward the market expectation of US policy rate increase. The baht appreciated in April, however, led by weaker-than-expected US employment and the FOMC minutes which reiterated the intention to normalize the policy rate only gradually. Contained domestic political situation also contributed to the baht appreciation in early April, resulting in **relative stability of the Thai baht**. **Government bond yields declined slightly since the last meeting,** in tandem with the US Treasury and as a result of lower expected issuance of government bonds amid a delay in large-scale public investment. Net capital inflows resumed in both equity and bond markets since April.

Nearly all market participants expected the Monetary Policy Committee (MPC) to maintain the policy interest rate at this meeting, citing already accommodative monetary policy stance. Market participants also noted that a further easing of monetary policy may not provide a meaningful boost to the economy, given that the main headwind to recovery was the ongoing political situation.

In their discussion of financial market developments, **the committee noted the relative stability of the Thai financial markets at present**. Volatilities of both the exchange rate and capital flows were contained, while a decline in government bond yields and narrowing corporate bond spreads helped lower borrowing costs for the private sector. Thus, financial conditions remained conducive to an economic recovery. At the same time, the committee acknowledged the risks that market developments could change quickly. Members considered stable and accommodative financial conditions as vital to maintaining market confidence, and fostering economic recovery and macroeconomic stability in the long-run.

The International Economy

The global economy improved at a gradual pace, led by the US and Euro area economies, although the Japanese economy decelerated, and risks in the Chinese financial sector have increased. The US economy continued to expand after the temporary effect of cold weather.

The Euro area economies continued to recover, on the back of the domestic demand and exports. **The Japanese economy** moderated as domestic demand fell short of expectation in the first quarter, with the increase in consumption tax impeding private consumption. **The Chinese economy** saw slowing domestic demand and a contraction in exports. Risks in the financial sector have increased, following defaults in corporate bonds with credit ratings below AA as well as the trust products. Tighter government regulations led to slowing activity in the real estate sector. **In Asia**, especially ASEAN, exports benefited from the advanced economies' recovery while domestic demand generally decelerated. **Global inflationary pressure remained low** and most central banks kept their policy interest rates unchanged. The Reserve Bank of New Zealand however increased the policy rate on 13 March 2014 from 2.50 to 2.75 percent in response to inflation concerns.

The MPC discussed economic policies set out by the Chinese government. These included the rebalancing toward consumption in place of investment as a driver of growth, urbanization policy to expand developments to the inner cities, as well as the promotion of labor mobility to support domestic demand growth. Furthermore, one member saw the need to monitor elections in India and Indonesia, the results of which could have implications for these countries' policies, the global economy, as well as cooperation with the ASEAN countries going forward.

<u>The Thai Economy</u>

Growth in the first quarter of 2014 was expected to contract by more than previously assessed on account of both public and private spending, as well as tourism, which have felt more impact from the ongoing political situation. Exports of goods gradually improved but could not compensate for the overall slowdown. Looking ahead, the recovery path would hinge mainly upon the political developments. Prolonged political situation and delay in forming a functioning government will have repercussions for the enactment of the 2015 Budget Act and public spending. Private investment has softened from fragile business confidence amid uncertain outlook for public investment. Businesses have also postponed new investment given ample spare capacity from previous investment. Private consumption has not gained traction due to subdued income growth and elevated household debt burden. The outlook for tourism should benefit from the lifting of the emergency decree in Bangkok and its vicinity. Exports of goods should improve in tandem with trading partners' growth. But the slowdown in China could weigh on the exports of some consumption goods, including rubber and cassava. Meanwhile, border trade has been expanding well, commanding a rising share of total exports.

The MPC projected the Thai economy in 2014 to expand less than previous assessment, from weaker-than-expected economic momentum in the first quarter, with political impasse posing greater downside risks to domestic demand and tourism. **However, the economy should be able to resume its normal growth next year.** Inflation rose as expected, following a pass-through of LPG costs to prepared food price, but demand pressure on prices remained subdued. One member noted the possibility of higher inflationary pressure, should there be further withdrawals of government subsidies on energy or other public services.

In the committee's view, **the debt-servicing abilities of low-income households as well as small and medium enterprises warranted monitoring**, as they could deteriorate further with economic slowdown. To manage this risk, financial institutions have tightened credit standards, particularly for personal loans, and introduced measures to manage debt-servicing burden for some customers. The banking system itself remained sound, as commercial banks have previously increased their loan loss provision and strengthened their capital buffer.

The MPC expressed concerns over several structural issues, which, if not addressed in a timely manner, could restrain potential growth in the long run. These issues included: (1) Structural fiscal constraints as reflected by a low revenue base relative to GDP and a high share of current expenditures relative to investment. Without a public finance reform, it would be difficult to balance the budget on a sustainable basis, especially given aging demographics and higher social welfare liability; (2) Inequality, in terms of income distribution, access to education and healthcare, has worsened despite continued economic expansion. Failure to address these problems could undermine long-term social and economic stability; (3) Supply bottlenecks, such as labour shortages and challenges to improving productivity and creating higher value-added products, could reduce Thailand's attractiveness for long-term foreign capital and competitiveness in the world market; and (4) The sustainable use of natural resources, given rapidly expanding number of tourists. The MPC concurred that these structural issues could not be resolved by monetary policy, but required concerted efforts and cooperation from all stakeholders.

Monetary Policy Deliberation

The committee deemed prolonged political uncertainties to be the main cause for higher downside risks to growth, while room for further policy accommodation was diminishing. Two key issues were discussed: (1) The need to maintain accommodative financial conditions to support the economy in the short run; and (2) Possible side effects that might arise from a prolonged period of low interest rates. The majority of the committee agreed that financial conditions were not hindering economic activities. Based on a range of measures, the degree of monetary policy accommodation was assessed to be relatively high and thus remained supportive to growth.

Six members voted to maintain the policy rate at 2.00 percent per annum with the following rationales: (1) Monetary policy remained adequately accommodative to support the economy in the short run. Remaining policy space should be conserved as further policy easing would likely yield limited growth benefits amid lingering political uncertainties; (2) Maintaining the policy rate was conducive to safeguarding stability in the domestic financial markets; (3) Financial institutions continued to function normally in supporting the economy and assisting customers to manage short-term difficulties, despite some tightening in credit standards ; and (4) Potential side effects of a prolonged period of low interest rates, and implications for financial stability, needed to be taken into account.

One member voted to reduce the policy rate by 0.25 percent as downside risks to growth remained elevated from uncertain domestic demand outlook. The pace of export recovery was also subject to uncertainties. Thus, monetary policy should be eased further in order to send a clearer signal of continued accommodative policy stance.

The MPC thus voted 6 to 1 to maintain the policy rate at 2 percent per annum.

Monetary Policy Group
7 May 2014