Edited Minutes of the Monetary Policy Committee Meeting

Bank of Thailand

18 June 2014

Publication Date: 2 July 2014

Members Present

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

The Financial Markets

The Thai baht depreciated and bond yields rose briefly after the major political change on 22 May 2014, before stabilizing following clearer direction in public policy management and measures to support the economy. In May, **the Thai baht** depreciated on weak economic data and political uncertainties. The political change led to a 20 Satang depreciation, with the baht weakest on 2 June at 32.89 against the US dollar. The baht appreciated thereafter on improving consumer confidence and resumption of foreign inflows into the stock market. **Government bond yields** edged lower slightly in May due to demand to roll over maturing bonds and lower expected supply of new issues. The political change prompted some short-term profit taking by foreign investors, pushing up yields. Also, expectations of greater government spending from the regular budget and infrastructure investment eased market concerns about the new bond supply and economic outlook. As a result, medium- and long-term government bond yields edged up towards the end of May.

Most market participants expected the MPC to maintain the policy rate at this meeting, given lower downside risks to growth following the political resolution. Scope for further monetary easing is also limited given already negative real interest rates and higher inflation.

The MPC discussed the market's more positive assessments of the economic outlook following a reduction in political uncertainties and clearer direction of economic policies. Credit rating agencies have also reaffirmed Thailand credit rating and deemed the Thai economic fundamentals to be strong.

The International Economy

The global economy continued to recover led by the US, while the euro area and Japan recovered at a gradual pace. In China, the risks in the financial sector and economic slowdown moderated somewhat. The US economy expanded after a temporary setback in the first quarter, with stronger labour market, housing sector, and private investment supporting the economy. **The euro area economies** slowed in the first quarter, prompting the European Central Bank (ECB) to introduce additional monetary measures to stimulate domestic credit and reduce the risk of deflation. **Japan** saw contraction in domestic demand as a result of consumption tax hike, but the market held off its expectation of further monetary easing by the

Bank of Japan given accelerating inflation. In **China,** economic activities began to stabilize after the first-quarter slowdown, while money market rates stabilized following short-term improvement in business confidence. **Asian economies** remained steady, with domestic demand moderating, and exports providing impetus to growth. Slower expansion in global trade could, however, pose challenges to exports going forward.

Global inflationary pressure remained low and most central banks kept their policy rates unchanged. The Reserve Bank of New Zealand, however, increased the policy rate for the third consecutive time from 2.50 in February 2014 to 3.25 percent in June 2014 in response to accelerating inflation stemming from non-tradable goods' prices and above-trend growth.

The MPC agreed that the global economy has strengthened, and discussed remaining risks that warrant monitoring, including: (1) The effectiveness of ECB liquidity-injection measures, which might have a limited effect on the real economy; (2) Shadow banking risks in China and the potential recurrence of corporate defaults, with possible repercussion on economic growth, although buffer in the banking sector should be adequate; and (3) Changes in trade network, with intra-ASEAN trade increasingly replacing exports to China, and a shift in supply chain away from China given higher production costs.

<u>**The Thai Economy**</u>

Growth in the first quarter of 2014 contracted more than expected, as political uncertainties weighed on domestic demand and tourism. Government spending, particularly public investment, was constrained by the absence of a fully functioning government. A tepid recovery in exports offered only a partial offset to the softening growth. Latest indicators, however, pointed to some stabilization in private demand. Inflation edged up somewhat from a pass-through of energy costs to prices of prepared food. **Looking ahead, the economy was projected to recover on the back of improving domestic demand following the political resolution.** Fiscal policy should lend greater support to growth, through accelerated disbursement of the 2014 fiscal budget, timely preparation for 2015 fiscal budget, infrastructure investment as well as other fiscal measures. Private consumption and investment should recover on the back of improving private confidence and fiscal relief measures including repayments of overdue debts under the rice pledging scheme. Recovery in exports of goods should be more evident in the latter half of the year, as trading partners' demand strengthens. But export growth may be limited by low commodity prices, slower demand recovery of some trading partners, domestic structural constraints and shifting global trade pattern. Tourism sector may also recover only slowly due to visiting countries' security concerns.

On balance, the committee revised growth projections up from last meeting to 1.5 percent for 2014 and 5.5 percent for 2015. The upgrade can be attributed to an improvement in public spending and a recovery in private demand after political uncertainties waned. Tourism should contribute more to growth in 2015. Inflationary pressure was higher than the previous assessment as a result of larger-than-expected costs pass-through to prepared food's prices.

Regarding financial stability, households' debt-servicing ability declined from falling income. Credit quality, particularly for auto loans, deteriorated somewhat. Profitability and ability to service debt of some corporations also saw greater impact from economic and political uncertainties. **However, financial stability risks were confined to the low-income households and SMEs, and did not pose a systemic threat.** Banks continued to tighten credit standards on new loans, but were also providing support to existing customers facing short-term difficulties. Looking forward, concerns about private debt-servicing ability and credit quality should ease with economic recovery, which in turn hinges partly on timely and effective implementation of government policies.

Some members highlighted remaining risks to a recovery, as follows: (1) Large outflows of migrant workers could further tighten the labour market and exert upward pressure on wages, given labour shortages in sectors such as agriculture, fishery, and services; (2) Possible ramifications on Thailand's international trade relations with its trading partners due to unintended consequences of domestic policies such as those related to labour; and (3) Efficiency of budget disbursement might be lower than target, curbing the contribution of public spending to growth.

The committee noted the importance of monitoring long-term risks to fiscal sustainability. Key issues included the structural shortfall of government revenues relative to expenditures, and legal loopholes allowing off-budget spending without formal parliamentary approval. Agenda for fiscal reform should aim to create a credible framework to safeguard fiscal discipline, while preserving sufficient flexibility for needed fiscal measures in exigent circumstances.

Monetary Policy Deliberation

The committee judged that Thailand's economic recovery should pick up pace in the second half of this year, given reduced political uncertainties and a resumption of functioning public policy management. The committee discussed how the role of monetary policy should adapt with changing circumstances. **Members agreed that more active fiscal policy should lend support to the economic recovery while prevailing monetary policy stance remained accommodative as well as conducive to safeguarding long-term financial stability**.

All seven members voted to maintain the policy rate with the following rationales: (1) The Thai economy should recover in the second half of this year, as reduced political uncertainties and clearer public policy led to improving private sentiments, lending support to domestic demand. Targeted fiscal policies, such as the repayment to farmers in rice pledging scheme and liquidity provision to SMEs through specialized financial institutions, should help support those sectors that are more vulnerable to economic slowdown and reduce their financial fragility; (2) Current financial conditions remained sufficiently accommodative in supporting a sustained economic recovery, with real interest rates continuing to be negative and the Thai baht remaining stable. Some members noted that higher inflation had pushed real interest rates further into the negative territory; (3) While inflation remained well within target, short-term inflationary pressure has edged up higher than previously assessed; and (4) Maintaining the policy rate was appropriate against the backdrop of stable domestic financial markets and impending interest rate normalization in major economies.

The MPC thus voted unanimously to maintain the policy rate at 2.00 percent per annum.

Monetary Policy Group
2 July 2014