Edited Minutes of the Monetary Policy Committee Meeting

Bank of Thailand

22 June 2016

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Members Present

Veerathai Santiprabhob (Chairman), Mathee Supapongse (Vice Chairman), Paiboon Kittisrikangwan, Jamlong Atikul, Sethaput Suthiwart-Narueput, and Apichai Boontherawara

Member Absent

Porametee Vimolsiri

The Global Economy

Despite signs of recovery in the G3 economies on the back of improvement in private consumption, Thailand's trading partners overall recovered at a slower pace than assessed in the previous meeting. While economic indicators for the **US economy** pointed to a continued recovery and the **Japanese economy** was expected to gain further traction thanks to the announced postponement of the increase in sales tax, forward momentum from G3 economies was not sufficient to offset the impact from the slowdown in **China** on **Asian economies' exports**. In addition, Asian exports were negatively affected by changes in the global trade structure, such as the shift toward a domestic-based supply chain that reduced the needs for imports from Asia, and by Asian economies' loss of export market share to China in some high-technology goods. Weak exports would weigh on Asia's growth going forward.

The balance of risks to the global economy remained tilted to the downside. Two key risks that the Committee closely monitored were as follows. First, with regard to **China's financial stability**, corporate default risks had heightened. As a result, financial conditions in China could tighten further and potentially affect funding costs and corporate financing. Moreover, funding obtained outside the formal banking sector through channels such as securities firms and subsidiaries of fund companies was on the rise. Although this development somewhat helped ease financial conditions in the near term, it could increase financial stability risks in China going forward. Second, regarding the impact on the global economy of the **United Kingdom's referendum on European Union (EU) membership**, the Committee assessed that the vote to exit the EU (Brexit) would create significant volatility in global financial markets in the short run and would adversely affect the UK's trade and investment in the longer run. In addition, uncertainties regarding potential exits by other EU members could further dampen cross-border trade and investment as well as the recovery of **European economies** and the global economy going forward. While the Committee estimated that the direct impact of Brexit on Asian economies would likely be small given limited trade linkages with the UK, the Committee would continue to monitor developments closely, especially if European economies were significantly affected.

The Financial Markets

Volatility in financial markets heightened since the previous meeting in May. Regional currencies initially depreciated following the anticipation of a rate hike by the Federal Reserve but subsequently appreciated after the release of US nonfarm payroll employment figures at the beginning of June that were lower than market expectations. During the run-up to this meeting, concerns over Brexit led investors to increase holdings of safe-haven assets and wait for the referendum results. Consequently, exchange rate volatility increased on some occasions; however, during this period, the **Thai baht against the US dollar** and the **Nominal Effective Exchange Rate (NEER)** averaged out close to the levels at the time of the previous meeting. The **Stock Exchange of Thailand (SET) index** increased slightly. Meanwhile, **Thai government bond yields** edged up across all maturities, owing partly to the recent release of Thailand's first-quarter gross domestic product figures that turned out better than market expectations, but yields remained below their 2015 averages.

The Committee expected volatility in international capital flows and exchange rates to persist in the period ahead. Major contributing factors included monetary policy divergence among major advanced economies and the increasingly fragile sentiment in global financial markets. Moreover, potential surges in global financial market volatility following Brexit would warrant close monitoring. However, spillover effects of higher volatility on Thai financial markets were likely to be limited, owing to Thailand's strong external positions that could help cushion the adverse impact from such developments.

<u>**Domestic Economic Conditions**</u>

The Thai economy continued to recover, supported by effective disbursement of the fiscal budget as well as tourism that grew faster than anticipated. The latter owed partly to the expansion of new international flight routes by low-cost airlines. Private consumption picked up on the back of growth in income and employment in the service sector. At the same time, income of agricultural households started to improve as a result of higher agricultural commodity prices, especially rubber, while concerns pertaining to the impact of the drought subsided. Nevertheless, some Committee members noted that the recent strength in private consumption was due to spending on entertainment and recreation, which might not be sustainable. Moreover, part of that spending was expenditure on trips abroad by Thai residents, which might not contribute much toward Thailand's potential growth in the long run. In this regard, the Committee would continue to monitor and assess the robustness of private consumption going forward. In addition, the Committee viewed that the service sector would become increasingly important to the Thai economy, and hence additional economic indicators for the service sector would be required for accurate economic assessment. Meanwhile, merchandise exports continued to contract, especially exports to Asian economies that were increasingly impacted by changes in the global trade structure. Such conditions meant that there remained excess production capacity in the manufacturing sector and therefore growth in private investment was expected to remain low, despite benefiting partly from public investment stimulus. The subdued private investment outlook was consistent with declining imports of raw materials and capital goods as well as the slowdown in commercial banks' credit expansion rate compared with historical average, in line with weak demand for loan by the business sector. Additionally, decreased drawings from credit lines extended by commercial banks suggested that the recent slowdown in credit growth could be primarily attributed to subdued credit demand.

The Committee expected the Thai economy to expand at 3.1 percent for 2016 as assessed in the previous meeting. Economic momentum from domestic demand and the tourism sector was anticipated to help offset the contraction in merchandise exports. **Nevertheless, there remained downside risks from weak demand from trading partners, diminished financial capacity of households to cushion future economic shocks due to elevated debt levels, and the fragile confidence of the private sector.** However, concerns pertaining to the impact of the drought subsided with the return of seasonal rainfall. For 2017, domestic demand was still expected to be the economy's main growth driver with continued support from tourism. However, income from merchandise exports was likely to be affected by the delayed recovery of trading partners' economies. Consequently, the Committee revised down the growth forecast for 2017 slightly from 3.3 percent to 3.2 percent.

Inflationary pressure edged up slightly from the previous assessment in line with the recovery in domestic demand and higher energy prices. This was reflected in both the slight increase in core inflation and a further pickup in headline inflation from the acceleration in energy and fresh food prices in May. **Overall, the Committee projected that headline inflation and core inflation for 2016 would average at 0.6 percent and 0.8 percent, respectively. Headline inflation was expected to gradually rise and return to the lower bound of the inflation target within the latter half of 2016.** In 2017, headline inflation and core inflation were expected to average at 2.2 percent and 1.0 percent, respectively, subject to uncertainties in global oil prices and in the recovery of domestic demand going forward.

Overall financial stability was not deemed to be a concern. However, risks arising from the prolonged low interest rate environment continued to warrant close monitoring, particularly the search-for-yield behavior that could lead to underpricing of risks. In addition, there were signs of weakened debt serviceability among SMEs and households, as reflected by rising non-performing loan (NPL) ratios of SME and consumer loans and the rising share of special mention (SM) loans across all loan types.

<u>The Policy Decision</u>

The Committee voted unanimously to maintain the policy rate at 1.50 percent at this meeting. In deliberating monetary policy, **the Committee gave weight to Thailand's economic recovery which proceeded at the expected pace.** However, there remained downside risks from weaker-than-expected growth in trading partners and fragility in the private sector's sentiments. **The Committee also gave due consideration to the inflation outlook where headline inflation was projected to return to the lower bound of the inflation target within the latter half of 2016 as previously anticipated.** The Committee assessed that inflationary pressure would pick up gradually with the ongoing economic recovery and rising global energy prices, and that medium-term inflation expectations remained well-anchored around the inflation target. In addition, **the Committee judged that monetary conditions remained accommodative and conducive to the economic recovery** as reflected in low real interest rates. Total corporate financing and household credits also continued to expand, although certain businesses faced limitations in gaining access to credit. Incidentally, **some members of the Committee viewed that keeping the rate on hold at this meeting would also help preserve policy space for future needs**, should the ongoing economic recovery be affected by risks such as financial stability concerns in China as well as Brexit.

Looking ahead, the Committee concurred that monetary policy should remain sufficiently accommodative. The Committee would stand ready to utilize an appropriate mix of available policy tools in order to support the economic recovery and ensure financial stability.

Monetary Policy Group
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