Edited Minutes of the Monetary Policy Committee Meeting (No. 4/2017)

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Members Present

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The Global Economy

The growth outlook of Thailand's trading partner economies improved slightly from the previous meeting underpinned by continued growth momentum. The **US economy** was expected to gain further traction on the back of private consumption that was supported by labor market conditions, which was approaching full employment, and strong household financial positions. The **euro area economy** continued to recover driven by domestic demand that benefited from accommodative financing conditions, rising employment, reduced political uncertainties after the results of the French presidential election, and improved exports growth. The **Japanese economy** recovered at a gradual pace mainly on account of exports, while domestic consumption was supported by accommodative monetary policy and improved labor market conditions. **Asian economies** continued to recover, driven by exports to G3 economies and growth in exports of technological products especially electronics. Nevertheless, Asian exports to China were expected to soften somewhat, as the **Chinese economy** slowed down due to ongoing economic structural reforms that placed greater emphasis on long-term stability. **Headline inflation** was expected to slowly rise in most trading partners' economies due to several factors such as the decline in global oil prices and domestic demand recovery that was not sufficiently strong. Meanwhile, core inflation remained broadly stable. Looking ahead, inflation expectations decreased slightly in G3 economies but remained largely unchanged in most Asian economies. In addition, **most central banks kept the policy interest rates unchanged over the intermeeting period** except for the Federal Reserve (Fed) which raised the target range for the federal funds rate by 0.25 percentage point to 1.00–1.25 percent at the meeting on 13-14 June 2017. Most analysts expected the Fed to start its balance sheet normalization earlier than previously expected and to raise the federal funds rate once more over the remainder of this year.

The Committee assessed that the balance of risks to the global economic recovery remained skewed to the downside especially due to risks associated with US economic and foreign trade policies, China's economic structural reforms, and geopolitical risks. **However, the degree of uncertainties declined overall.** Particularly, upside risks decreased as the swift implementation of US economic stimulus policies became less likely. Downside risks also decreased, as concerns over the possible breakup of the European Union (EU) subsided after pro-EU political parties claimed victory in the French and Italian elections.

The Committee noted the following points. First, despite overall improvements in economic growth and labor market conditions, the softer inflation outlook for the G3 economies was partly attributable to country-specific factors. For the US, these included (1) cheaper mobile phone plans whose impact was estimated to be transitory and (2) wage negotiations that were based on backward-looking price increases. Meanwhile, hiring in the EU was still geared toward temporary workers rather than full-time employees. However, if economic growth were to accelerate going forward, inflationary pressures might ratchet up and central banks in G3 economies might have to raise their policy rates earlier than previously expected. Second, private investment remained low in many countries partly due to high corporate debt levels and political uncertainties, both of which were considered risks that could affect the ongoing global economic recovery.

The Financial Markets

Overall sentiments in global financial markets improved as investors' concerns over the US political situation eased. At the same time, the market expected monetary policy normalization in G3 economies to proceed at a gradual pace given (1) low inflationary pressures, (2) the outline of the Fed's balance sheet normalization plan which turned out as expected, and (3) the lack of clarity in the implementation of US economic stimulus policies. **Consequently, improvements in investors' sentiments led to larger-than-expected increases in asset prices in global financial markets and capital inflows to regional countries, especially into bond markets.** Nevertheless, recent portfolio inflows to Thailand were smaller in size compared with inflows to other countries in the region. In addition, demand for long-term Thai government bonds from both foreign and domestic investors, coupled with the slowdown in inflation, resulted in a somewhat significant decline in **long-term government bond yields** from levels seen at the previous meeting. Meanwhile, short-term Thai government bond yields declined somewhat due to the reduction in short-term bond issuances by both the BOT and the Ministry of Finance. The **Stock Exchange of Thailand (SET) Index** was largely unchanged relative to regional equity indices that went up with prices of technology stocks, which constituted only a small share in the SET Index. With regard to the exchange rates, the **baht appreciated against the US dollar** to a greater extent than other regional currencies in some periods due to steady US dollar sales by Thai exporters. As a result, the **Nominal Effective Exchange Rate (NEER)** appreciated from the last meeting. Nevertheless, Thailand's relatively low inflation compared with overall trading partners helped the **Real Effective Exchange Rate (REER)** to appreciate less than the NEER. The **costs of financing and borrowing from commercial banks** remained unchanged after the benchmark retail interest rates were cut in earlier periods.

Going forward, the Committee anticipated capital inflows to regional financial markets including Thailand, given the gradual pace of monetary policy adjustment in G3 economies, combined with the attractiveness of Thai assets to foreign investors that were attributed to Thailand's strong external position. The Committee would thus continue to monitor short-term capital flows and encourage the private sector to continue giving due consideration to exchange rate risk management in light of capital flow and exchange rate volatilities.

Domestic Economic Conditions

Thailand's economic growth continued to gain further traction. Growth was driven primarily by a more broad-based expansion in **merchandise exports** across various export destinations and product categories, particularly electronics which accelerated thanks to the increasing popularity of Internet of Things (IoT) products as well as the relocation of production sites from Japan to Thailand. Meanwhile, **tourism** showed better-than-expected growth mainly on account of the number of Chinese tourists. **Private consumption** expanded at a gradual pace following more broad-based recovery in farm income across different regions in Thailand.

Nevertheless, overall purchasing power had yet to fully recover, as wages in the manufacturing sectors did not benefit much from the export recovery. This was partly because increases in working hours were so far limited to certain industries, namely food, electronics, and metal fabrication, while the average earnings in most manufacturing sectors had yet to increase. In addition, some Committee members noted that recent increases in private consumption through e-commerce might not fully be captured by current consumption indicators. This must be monitored more closely, as e-commerce would have important implications for consumer behavior and data compilation going forward. **Public expenditure** remained an important economic driver despite unexpected delays in some public investment projects due partly to delays in budget disbursement and difficulties in acquiring additional budget appropriations. Meanwhile, **private investment** recovered at a gradual pace and was still concentrated mainly among export-related businesses with good performances.

The Committee assessed that Thailand's growth outlook for 2017 improved further and that the economy would expand at a faster pace than previously projected. The growth forecast for 2017 was revised up from 3.4 percent to 3.5 percent. This upward revision was due to the better-than-expected outturn in the first quarter, as well as better-than-expected improvements in merchandise and service exports, which partly offset the impact of delays in public investment. Private consumption would gradually expand, while private investment was expected to grow at a more moderate pace than previously estimated. **Under the Committee's assessment, the Thai economy would continue to expand and achieve a 3.7 percent growth in 2018**, driven by both public investment and private spending. Meanwhile, exports were expected to grow but would soften somewhat due partly to (1) the slowdown in China's production of electronics, following prior acceleration, which might affect exports of Thailand that was part of the supply chain, (2) slowing rubber exports to China as the country pared down its elevated rubber stock and as rubber prices started to decline, and (3) structural difficulties faced by exporters in some industries, in particular automotive given production capacity expansion currently underway in regional countries. **On the whole, Thailand's growth would continue to improve further with lower forecast uncertainties. Notwithstanding, the balance of risks to the growth projection remained tilted to the downside similar to the previous assessment due to external factors.** These external factors included in particular uncertainties in US foreign trade policies, China's economic structural reforms, and geopolitical risks that could have adverse economic impacts on Thailand's trading partners. At the same time, the recovery in domestic purchasing power was not yet broad-based.

The Committee engaged in extensive discussion on the expected continuity of export growth. Some Committee members viewed that exports would continue with favorable growth given the expansion seen in maritime shipping volumes and the improved global economic outlook. Meanwhile, many industries had planned to increase their business investment in Thailand, which would also support export growth in the period ahead. Nevertheless, some Committee members viewed that there remained risks associated with declines in the global oil prices, which could affect exports of petroleum and petro-chemical products, together with risks stemming from uncertainties in US trade policies that continued to warrant close monitoring going forward.

Headline inflation was softer than expected in May and June 2017 due mainly to supply-side factors. In particular, fresh food prices declined on account of higher agricultural output thanks to favorable weather conditions coupled with the high base following last year's drought. Meanwhile, global oil prices also declined. As a result, headline inflation might fall below the lower bound of the target in some periods. **Core inflation** remained stable at low levels in line with subdued demand-pull inflationary pressures. In the near term, it was expected that demand pressures would pass through only slightly to core inflation, as positive spillovers from export expansion to domestic demand were limited so far. Moreover, the relationship between economic growth and inflation was weaker than in the past due to structural shifts and external influences on domestic inflation. This finding was in line with studies undertaken in the context of Thailand and other countries. Meanwhile, the public's **medium-term inflation expectations** remained close to the midpoint of the target.

Given the softer-than-expected inflation outturn in the first five months of this year and a more subdued outlook for fresh food and oil prices compared with the previous assessment, **the Committee revised down the headline inflation forecast for 2017 and 2018** to 0.8 and 1.6 percent, respectively. The **core inflation forecast for 2017 and 2018** was also revised down to 0.6 and 0.9 percent, respectively. Looking ahead, despite the forecast revision **headline inflation was expected to slowly rise over the latter half of 2017 and throughout the following year** as downward pressures from supply-side factors subsided. These included the base effects of higher fresh food prices that would dissipate gradually, the expected rise in global oil prices in tandem with the global economic recovery, an increase in electricity costs in Thailand in the second half of this year, and rising core inflation especially if domestic demand exhibited a clear and sustained recovery. Meanwhile, the **balance of risks to the inflation forecast tilted to the upside** as more stringent regulations on immigrant workers might tighten labor market conditions and in turn increase labor costs for businesses. The extent of such impacts would also depend on the implementation and management of the new regulations by the government. In addition, some Committee members noted that the impacts would be more pronounced in certain sectors such as manufacturing, construction, and services. Notwithstanding, some Committee members viewed that there would be more downward inflationary pressures from structural factors, including advancements in shale-oil production technology and the role of e-commerce that might contribute to sluggish inflation than expected.

The expansion of commercial bank loans remained low overall. Loans to large corporates started to expand across business sectors, while loans to small-and-medium sized enterprises (SMEs) continued to grow but were rather concentrated in some businesses such as real estate and hotels. Business financing through the bond markets continued to increase. Consumer loan growth turned positive in almost all loan purposes except credit card loans. Meanwhile, the number of loan applications and loan approval rates increased overall. Corporate loan utilization rates rose slightly especially for loans extended to large businesses. **Credit quality deteriorated** as reflected in rising non-performing loans (NPLs) in almost all loan categories, especially SMEs in many industries whose businesses were affected by several factors, such as declining competitiveness, limited recovery in consumers' purchasing power, and falling commodity prices. In any case, financial institutions maintained high levels of loan loss provision and capital buffers which provided cushion against deterioration in credit quality.

The Committee noted that, **despite overall improvements in economic growth, the continued deterioration in credit quality especially for SMEs might partly stem from SMEs' inability to compete with larger businesses**. Thus, the Committee saw a need to closely monitor developments of, and factors attributing to, NPLs at sectoral levels, as well as to develop economic indicators that would better reflect NPL trends. In addition, a few Committee members viewed that current situations on immigrant workers might affect SMEs and their debt serviceability. Furthermore, some Committee members noted that debt restructuring for SMEs might have been given a lower priority compared with larger businesses which caused the slow decline in NPLs among SMEs.

Monetary Policy Decision

The Committee assessed that Thailand's growth outlook improved further particularly on the back of external factors, while domestic demand expanded at a gradual pace and was not yet sufficiently broad-based. Headline inflation softened and might fall below the lower bound of the target in some periods due mainly to supply-side factors. Nevertheless, headline inflation was projected to slowly rise in the latter half of this year. Meanwhile, there remained financial stability risks under the prolonged low interest rate environment. **In deliberating their policy decision, the Committee discussed the need for accommodative monetary policy taking into consideration costs and risks** as summarized below.

(1) Thailand's growth outlook improved further driven mainly by merchandise exports, but domestic demand growth was not yet sufficiently broad-based. Most Committee members were concerned that SMEs did not gain much from the economic recovery partly due to their lack of competitiveness, thus potentially limiting distribution of income going forward. Several Committee members also added that current situations on immigrant workers might pose additional challenges for SMEs. Meanwhile, some Committee members expressed concerns on the continuity of export growth, as Thai exports might gain only limited benefits from the global economic recovery going forward, given that structural problems in manufacturing sectors that could affect their competitiveness remained largely unsolved. In addition, some Committee members viewed that an accommodative monetary policy stance was still warranted given low private investment and employment growth. Meanwhile, some Committee members viewed that Thailand's economic growth remained at risk if public investment did not proceed as planned.

(2) Headline inflation was softer than expected due mainly to supply-side factors but retained an upward trajectory in the latter half of this year. The Committee viewed that the decline in inflation, in which headline inflation might fall below the lower bound of target in some periods, was due to supply-side factors. However, the Committee expected inflation to gradually rise during the second half of this year and reach the lower bound of the target towards the end of this year or the early part of next year once the effects of the temporary supply-side factors dissipated, and demand inflationary pressure increased in line with projected economic expansion. Hence, further monetary policy accommodation in response to low inflation in this context deemed unnecessary. Nevertheless, there remained uncertainties in the inflation outlook and the period in which inflation would return to the target, and thus inflation developments must be monitored closely. Under the Committee's view, the current accommodative monetary policy stance would still be needed and would play a crucial role in supporting domestic demand and sustaining inflationary pressures going forward.

(3) Financial stability remained sound overall but there remained pockets of risks that continued to warrant monitoring. Most Committee members expressed concerns over debt serviceability of SMEs and the search-for-yield behavior in the prolonged low interest rate environment. The latter was partly reflected in increased investment in riskier assets relative to bank deposits, such as foreign investment fund (FIFs), deposits at saving cooperatives, and unrated bonds. These risk-taking behavior could lead to underpricing of risks and also to other financial imbalances that remained undetected.

In this light, the Committee unanimously voted to keep the policy rate unchanged at 1.50 percent at this meeting and concurred on the need to maintain accommodative monetary policy stance to support the continuation of economic growth, while preserving financial stability.

Monetary Policy Group
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