Edited Minutes of the Monetary Policy Committee Meeting (No. 3/2017)

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Members Present

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The Global Economy

The overall growth outlook for Thailand's trading partner economies improved from the previous meeting. Most economies recorded stronger-than-expected growth in the first quarter of 2017, with indicators of manufacturing production and global trade volume reflecting a continued recovery. G3 economies continued to expand on the back of private consumption while private investment gradually improved. The **US economy** slowed down more than expected in the first quarter on account of private consumption, which softened from temporary factors including previous acceleration in auto sales and delayed income tax refunds. Nevertheless, sound economic fundamentals, particularly employment and private sector confidence, should help support domestic demand and economic growth in the period ahead. **Asian economies** continued to recover, driven by improved exports to G3 and regional economies, especially China. **Looking ahead, the global economy was expected to continue expanding**. However, certain structural problems, including elevated private sector debt particularly in emerging market economies and moderation in productivity growth after the global financial crisis, might impede the global economic recovery going forward. **Headline inflation was expected to slowly rise in most economies**. Core inflation remained broadly stable partly due to the weaker relationship between economic growth and inflation than in the past. **In addition, major and regional central banks kept their policy interest rates unchanged over the inter-meeting period.**

The balance of risks to global economic recovery was largely unchanged from the previous assessment and remained skewed to the downside. The Committee assessed geopolitical risks to increase amid conflicts over the Korean peninsula. Some members viewed that global financial markets might become more volatile if such risks were to intensify. Risks associated with the US economic and foreign trade policies as well as China's economic structural reform remained in line with the previous assessments but still warranted close monitoring. Political concerns in Europe eased following the results of the French election. Meanwhile, the Committee viewed China's one-notch credit rating downgrade on 23 May 2017 as a realization of risks previously identified.

Under the Committee's view, key issues that warranted monitoring in the period ahead included (1) the impact of interest rate and balance sheet normalization by the Federal Reserve (Fed) and (2) the US tax reform policies with respect to repatriated earnings and their implications for cross-border capital flows. Moreover, the Committee assessed that the Fed would raise its policy rate twice over the remainder of 2017 in line with market expectations. The Committee also expected that the Fed's balance sheet normalization would likely proceed at a gradual pace, which would help facilitate expectations formation and orderly adjustments in financial markets.

The Financial Markets

The overall sentiment in global financial markets improved. The global economic recovery became more positive and political concerns in Europe eased, while conflicts over the Korean peninsula did not trigger significant concerns among investors. Consequently, prices of safe-haven assets including gold and the Japanese yen fell. Nonetheless, in mid-May investors were increasingly concerned over the political situation in the US and came to expect that further hikes in the federal funds rate this year might be less certain.

Market expectations about the gradual monetary policy normalization in G3 economies and the improved global economic outlook led to capital inflows to bond and equity markets in the region including Thailand. However, capital inflows to Thailand were smaller in size compared with inflows to other countries in the region. The **Stock Exchange of Thailand (SET) Index** declined on account of a fall in the prices of energy and bank equities respectively following the drop in global oil prices and increases in non-performing loans (NPLs) in the first quarter. With regard to the exchange rates, the **baht depreciated against the US dollar** to a greater extent than other regional currencies due to the accelerated US dollar purchases by gold-trading companies when gold prices dropped and the repatriation of profits and dividends by foreign businesses in Thailand. Thus, the **Nominal Effective Exchange Rate (NEER)** depreciated from the previous meeting. Meanwhile, **short-term Thai government bond yields** edged lower mainly due to reduced issuance of Bank of Thailand (BOT) bills. Meanwhile, short-term money market rates remained close to the policy rate and medium- to long-term Thai government bond yields were around the same levels as in the previous meeting. The **overall costs of borrowing** declined following the recent cuts in lending rates by some commercial banks, which resulted in **more accommodative financial conditions.**

It was expected that capital flow and exchange rate movements would remain volatile in the period ahead depending on (1) the actual implementation of US economic policies, (2) the political situation in the US, and (3) market expectations about the pace of the Fed's monetary policy normalization. Consequently, the Committee saw the need to closely monitor short-term capital flows especially those invested in short-term instruments.

The Committee discussed the reasons why investors did not give much consideration for geopolitical risks, as reflected by the continued increases in global equity indices. Some members viewed that investors might regard such risks as tail risks, which could be difficult and costly to hedge against, and that investors might be confident about the clearer global economic recovery. As a result, investors did not significantly adjust their risky asset position. Were geopolitical risks to materialize, risky assets in global financial markets might experience a sharp correction in prices.

Domestic Economic Conditions and Financial Stability

The Thai economy grew faster than previously expected in the first quarter of 2017, recording a growth rate of 3.3 percent from the same period last year. Growth was primarily driven by an increasingly broad-based expansion in **merchandise exports** to almost all destinations, especially China, and in many export categories, particularly electronics that picked up thanks to the uptrend of Internet of Things (IoT) products. **Private consumption** continued to expand on the back of expenditure on services and durable goods, especially cars, which rose across many regions supported by higher farm income and improved consumer confidence. Meanwhile, **tourism** and **public expenditure** continued to expand. Nevertheless, **private investment** growth remained mostly limited to export-related businesses, consistent with loan growth that was concentrated in certain industries.

The Committee assessed that Thailand's growth outlook improved further mainly on account of better-than-expected growth in **merchandise exports** as Thailand's trading partner economies gained momentum. However, the export recovery still faced risks stemming from uncertainties in US foreign trade policies which continued to warrant close monitoring. The recovery in **tourism** was expected to continue. Meanwhile, **private consumption** was expected to grow at a gradual pace. Nevertheless, the purchasing power of some agricultural households remained limited due to the debt burden following the severe drought last year. At the same time, non-farm income growth slowed down somewhat as growth in the manufacturing sector was largely limited to capital intensive industries. Unemployment, while remaining low overall, recently saw some increases among the new entrants which might reflect structural unemployment. **Private investment** was expected to slowly gain momentum as demand picked up, which would help to gradually reduce excess capacity. However, businesses still faced significant uncertainties on many fronts that might affect their investment decisions, including geopolitics, future technological trends, the direction of US foreign trade policies, and potential labor shortage in Thailand due to population aging. Additionally, some Committee members viewed that the slowdown in investment could be attributed to the fact that businesses still kept their hurdle rates at a high level as in the past, despite significant declines in financing costs over recent periods which could partly reflect some increase in risks. Meanwhile, the Committee expected **public expenditure** to continue to play an important role in boosting economic growth, although public investment would likely moderate somewhat due mainly to limited budget disbursement by some state-owned enterprises.

Headline inflation was softer than expected in March and April 2017 on account of lower prices of fresh food, especially vegetable and fruits, due to (1) this year's higher output as rainfall exceeded normal levels and (2) last year's base effect because of the drought. Headline inflation might thus fall below the lower bound of the target in some period primarily due to supply-side factors. **Core inflation** remained stable at low levels in line with low demand-pull inflationary pressures. Meanwhile, the public's **medium-term inflation expectations** remained close to the midpoint of the target.

Looking ahead, the Committee assessed that **headline inflation would trend up in the latter half of the year** driven by cyclical factors, which included an expected rise in global oil prices alongside the global economic recovery, an increase in electricity costs in the second half of 2017, and rising core inflation as demand-pull inflationary pressures would gradually increase in tandem with economic growth. The positive effects of these cyclical factors on inflation were expected to help counteract the negative effects of structural factors, including aging population and an expansion of e-commerce, which could become more prominent in the period ahead.

Overall, most Committee members assessed that the decline in headline inflation over the past two months was a result of temporary supply-side factors. Headline inflation was expected to rise over the latter half of the year in tandem with economic growth and as the base effect of higher fresh food prices last year dissipated. Meanwhile, the public's medium-term inflation expectations remained close to the midpoint of the target. Nevertheless, some Committee members viewed that headline inflation might fall below the lower bound of the target in some period and saw the need to assess factors, both cyclical and structural, that might affect the inflation outlook in a comprehensive manner.

The expansion of commercial bank loans remained low overall. Loans extended to large businesses and small-and-medium sized enterprises (SMEs) continued to grow but were largely concentrated in some business sectors. Nevertheless, business financing through the bond market continued to increase. Meanwhile, consumer loan growth slowed down in almost all categories except for auto loans, which remained contracting albeit at a slower pace. **Credit quality continued to deteriorate** as reflected in rising NPLs especially among business loans extended to SMEs and mortgage loans, as well as increasing credit migration to lower credit quality among SMEs, which continued to warrant close monitoring going forward. In any case, financial institutions maintained high levels of loan loss provision and capital buffers, which provided cushion against potential risk from deterioration in credit quality.

Some Committee members noted that **the deterioration in credit quality partly reflected the fact that current economic growth was not yet broad-based and might be a result of ongoing structural changes**, including (1) the greater use of automation in manufacturing production that might limit the positive spillovers from the export recovery to employment and household income, (2) excess capacity in some business sectors following significant capacity upgrades in earlier periods, together with businesses' limited ability to adapt to the changing economic environment, and (3) lower competitiveness of SMEs compared with large firms that in part reduced debt serviceability to some extent. Most Committee members viewed that these **structural challenges could not be addressed by monetary policy or demand-side policies alone but required structural reforms as well.** At the same time, some Committee members saw the need to develop economic indicators to assess economic conditions at the micro level, especially with regard to labor and household income. These indicators would be beneficial to policy makers, as they would allow for a deeper understanding of behavior and welfare of citizens in various parts of the economy and would aid in assessing the ongoing recovery in a manner that would be comprehensive and reflective of the structural changes in the economy, with implications for the conduct of monetary policy going forward.

The Committee engaged in an extensive discussion on the BOT's preliminary study on **Thailand's long-term potential growth.** The assessment in the study was based on the projected trend growth of factors of production such as hours worked, labor quality, capital, and total factor productivity (production function framework) that incorporated several structural changes in the economy such as population aging, adoption of productivity-enhancing technology, and large-scale infrastructure investment. According to some Committee members, **Thailand's potential growth would likely decline** due to a wide range of factors such as (1) a declining labor force due to population aging, (2) skill mismatches in the labor market that could lead to underutilized capacity, and (3) slower productivity growth due to investment shifts toward the service sector that required less capital investment and had lower sectoral productivity. Going forward, however, should the government be able to successfully carry out large-scale infrastructure investment and promote new industries under the S-curve project as planned, Thailand's potential growth could increase. Meanwhile, some Committee members viewed that the assessment of Thailand's potential growth must also account for factors such as (1) the increasing use of automation in manufacturing, (2) investment in intangible assets such as human resource development and intellectual property, and (3) the use of immigrant labor in place of the aging workforce. Taking the above factors into account would allow a more comprehensive analysis that yielded meaningful implications for the conduct of monetary policy to close the output gap within an appropriate time horizon, and for structural reform policies to uplift potential growth in the long term.

The Committee viewed that financial stability remained sound as reflected in the financial health of commercial banks and businesses, especially listed companies, and the slowdown in debt accumulation by both households and businesses. However, there remained pockets of risks that still warranted close monitoring such as the deterioration in the quality of loans extended to households and businesses, especially low-income households and SMEs. Meanwhile, risks of system-wide asset price bubbles remained limited given that asset prices stabilized in both securities and housing markets. At the same time, risks pertaining to the rollover of unrated bonds eased somewhat as financing costs for new bond issuances did not significantly increase, although the rollover of unrated bonds maturing in the near term continued to warrant monitoring.

The search-for-yield behavior in the prolonged low interest rate environment remained present. Foreign investment funds (FIFs), especially those that invest in short-term deposits, continued to grow. However, risks remained contained as most funds invested in countries with investment grade credit rating. In addition, saving cooperatives' asset size continued to increase. Some saving cooperatives with deposits and borrowings in excess of members' loan demand might seek higher yields by investing more in risky assets. Some saving cooperatives with insufficient financing from members might rely on short-term borrowing or resort to attracting deposits through higher interest rates to finance their lending operations. In both cases, mismanagement of their operations might affect confidence of cooperatives' members, and thus the Committee saw the need for a close monitoring. Some Committee members also saw the need for a close cooperation between various regulatory agencies to close any regulatory gap and to detect potential risks in order to address those risks in an appropriate and timely manner.

<u>Monetary Policy Decision</u>

The Committee discussed and exchanged views on important issues that had implications for the policy decision as follows.

(1) While Thailand's growth outlook improved further mainly on account of exports, growth was still limited to some parts of the economy and was subjected to greater risks on the external front. Some Committee members expressed concerns with regard to the contraction in private investment and noted that export-related businesses that enjoyed growth in the recent period still possessed a fair amount of excess capacity which might delay new investment. As such, maintaining interest rates at low levels remained necessary to support growth. Other Committee members added that improvements in the growth outlook would initially benefit larger businesses more than smaller firms partly due to SMEs' limited capacity to adapt.

(2) Headline inflation was softer than expected due mainly to supply-sided factors but retained an upward trajectory in the latter half of the year. Most Committee members viewed that further monetary policy accommodation at this time might have limited consequences for inflation. Some Committee members viewed that a continued decline in the public's medium-inflation expectations and deflationary risks were unlikely to materialize as private spending continued to show improvements. In addition, some members viewed that inflation would mainly be driven by developments in global oil prices. As global oil prices were expected to stabilize or edge up somewhat, there would not be downward inflationary pressures as in earlier periods. However, headline inflation might experience further fluctuations depending on fresh food prices. One Committee member noted that medium-term inflation expectations declined somewhat despite remaining close to the midpoint of the target, and thus warranted close monitoring going forward.

(3) Financial stability remained sound but there were pockets of risks that continued to warrant monitoring, namely the deterioration in debt serviceability of SMEs and the search-for-yield behavior. Some Committee members concurred that NPLs in some sectors might not decrease as the economy continued to expand due to structural challenges such as businesses' inability to adapt. Some members were also concerned about the ongoing search for yield in the low interest rate environment as well as other potential financial imbalances that remained undetected.

In deliberating their policy decision, the Committee assessed that Thailand's growth outlook further improved, while headline inflation softened on account of supply-side factors but retained an upward trajectory in the latter half of the year. Nonetheless, growth was still limited to some parts of the economy and faced with risks on the external front. The policy rate should thus remain low at its current level in support of continued and more broad-based growth. Meanwhile, some Committee members regarded the preservation of policy space as important given domestic and external uncertainties. **In this light, the Committee unanimously voted to keep the policy rate unchanged at 1.50 percent at this meeting in order to maintain an accommodative monetary policy stance to support the continuation of economic growth, while preserving financial stability.**

Monetary Policy Group
7 June 2017