Edited Minutes of the Monetary Policy Committee Meeting (No. 3/2023)
26 and 31 May 2023, Bank of Thailand
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Members Attending[1]

Sethaput Suthiwartnarueput (Chairman), Mathee Supapongse (Vice Chairman), Roong Mallikamas, Rapee Sucharitakul, Somchai Jitsuchon, and Subhak Siwaraksa

The Global Economy and Financial Markets

Trading partner economies were projected to grow 2.6 and 2.7 percent in 2023 and 2024, respectively. The outlook for both the US and Europe improved from the services sector. The Chinese economy expanded at a robust pace in the first quarter of 2023 following its reopening, though latest indicators suggested some moderation in economic activity. China's high level of manufacturing inventories and greater reliance on its domestic production capabilities have limited the reopening's spillover benefits to other Asian economies. Nonetheless, Asian exports were expected to improve and recover in the second half of 2023. **Looking ahead, the global economic outlook remained uncertain**, due to the lagging effects of major central banks' monetary policy actions as well as lingering geopolitical risks.

Global financial markets were supported by better risk sentiments. Improving global economic outlook, slowing inflation, and contained banking stresses in the US and Europe helped alleviate investors' concerns. Financial market participants expected the Federal Reserve to slow the pace of monetary policy tightening, lending support to risky asset prices and capital flows into some countries in the region.

Domestic financial conditions turned less accommodative, as the private funding costs rose in line with higher policy interest rate. Overall financial conditions remained supportive of fund mobilization, which should expand at a pace consistent with the economic recovery. Domestic bond yields increased in tandem with the policy rate, with long-term yields also partly influenced by higher US Treasury yields.

The baht depreciated against the US dollar, on (1) the Federal Reserve's monetary policy outlook, (2) the renminbi depreciation which induced broader effects on regional currencies, and (3) domestic political uncertainties before and after the election. With global financial markets remaining uncertain, the Committee would continue to monitor the developments of global financial conditions, major central banks' monetary policy, and China's economic outlook.

Domestic Economy

The Thai economy should continue to expand, driven mainly by tourism and private consumption, with 2023 and 2024 growth projected to be 3.6 and 3.8 percent, respectively. The tourism sector should continue to recover robustly, reflected by the higher-than-expected foreign tourist arrivals across almost all nationalities. Foreign tourist arrivals were revised upward to 29 million for 2023 and 35.5 million for 2024, compared to previous projections in March 2023 of 28 and 35 million in 2023 and 2024, respectively. Private consumption should gain further traction, propelled by the improvements in overall employment and labor income, notably in the services sector and among self-employed

[1] Kanit Sangsubhan resigned from the Monetary Policy Committee on 24 April 2023.

workers benefiting directly from the tourism recovery. Merchandise exports, which had contracted since the end of 2022, were recovering gradually and should pick up pace in the second half of 2023, thanks to China's reopening and improvement in trading partner economies. Exports of agricultural and agro-manufacturing goods to China and electrical appliances to the US and Europe were relatively strong in the first half of 2023, recovering faster than those of other regional countries. **Looking forward**, **upside risks to growth include (1) higher-than-expected foreign tourist arrivals and spending and (2) a stronger stimulus from the new government's economic policies taking effect in 2024**. Downside risks to growth stemmed from the softening of global economic activity and domestic political uncertainties, which warranted monitoring. **On balance, the upside risk to growth dominated throughout the projection horizon.**

Headline inflation returned to the target range and was projected to be 2.5 and 2.4 percent in 2023 and 2024, respectively. Easing supply pressures from lower domestic electricity and diesel prices were one driver. The base effect from unusually high inflation last year also explained the slowdown in headline inflation, but this effect should gradually dissipate in the latter half of 2023. **Core inflation remained elevated** and was projected to stabilize at 2.0 percent in 2023 and 2024. Underlying inflation indicators remained high despite some slowdown, while core inflation was driven importantly by the food-in-core components which have been persistent in their ascent. **The upside risk of inflation** could come from two factors. First, demand pressures could mount given the backdrop of expanding economic activities, particularly if tourism recovery or fiscal stimulus under the new government's economic policies proved stronger than expected. Second, the pass-through of costs absorbed by producers in the past could increase given persistently high production costs. In this context, further supply pressures could have implications for price-setting behavior. On the downside, new government subsidies of living costs and slower-than-expected global recovery could weigh on inflation. **On balance, the risk of inflation was tilted to the upside throughout the projection horizon.**

<u>Highlighted Committee Discussion</u>

- **The Committee agreed that upside risks to inflation remained, and that the inflation persistence may be higher than in the past**. Cost pass-through could increase as businesses sought to raise prices in light of stronger household demand on the back of economic expansion and possible fiscal stimulus. Over the long term, climate change would put pressure on raw food inflation, making it higher and more persistent. For example, the El Niño phenomenon would exacerbate and prolong droughts, raising prices of vegetables and fruits. In addition, higher costs of animal feed and fewer farmers could result in higher prices for meat, especially pork. Greater cost pass-throughs and more frequent price adjustments could have implications for inflation expectations and price-setting behavior in the future.
- **The Committee acknowledged that future inflation dynamics would be contingent in part on forthcoming government policies**. The possible minimum wage increase in particular could prompt a higher pass-through of labor costs onto the price of goods. Indexing the minimum wage to inflation could further amplify the pressure on labor costs and goods prices, possibly giving rise to a wage-price spiral phenomenon with implications for long-term price stability. Such risks, however, should be limited by several attributes of the Thai labor market: (1) high labor market flexibility given supply of foreign workers and

labor mobility across different sectors, (2) low bargaining power of Thai workers compared with other countries, (3) a low share of labor costs, at 15 percent of the total production costs for an average business, limiting the scope for labor cost passthrough, and (4) a relatively small share of wage earners – 45 percent of the total labor force, compared with 90 percent in advanced economies such as the US, Germany, and the UK. As such, the impact of a minimum wage increase on aggregate demand and risks of a wage-price spiral appeared limited relative to other countries. The Committee nonetheless agreed to closely monitor the impact of the new government policies and assess their inflation implications, including through wages, firms' price setting behavior, and the public medium-term inflation expectations.

- **The Committee expected a continuation of economic expansion, with some upside risks.** Tourism and private consumption would provide the main impetus, with goods exports likely to recover in the second half of 2023. China's economic and policy developments would be key determinants of export and tourism trajectories. Upside risks to growth came from foreign tourist arrivals and forthcoming government fiscal and economic policies, which could lead to stronger-than-expected domestic demand especially in 2024. At the same time, uncertainties pertaining to the global economic outlook and formation of the new government posed downside risks to the Thai economy.

- **The Committee assessed financial conditions to be less accommodative since the previous meeting, in line with a higher policy rate**. Current financial conditions nonetheless remained supportive of fund mobilization by the private sector. The Committee remained concerned over the financial positions of the vulnerable groups, especially SMEs and low-income households with high levels of debt. Targeted measures aimed at addressing these problems in a sustainable manner, such as debt restructuring, continued to be more efficient and cost-effective than a blunt policy instrument such as the policy interest rate.

- **In the Committee's view, the real policy interest rate that prevails in the long run once the economy returns to its potential should at least be in the positive territory**. Such a neutral real interest rate would appropriately balance savings and investment, thereby sustaining economic activity at its full potential without inducing inflationary pressures. Sufficiently high real interest rate would also help guard against search-for-yield behavior and excessive financial risk-taking, thus fostering long-term financial stability. In deliberating future policy, the Committee would continue to take into account near-term macroeconomic and financial risks that may have implications for growth and inflation trajectories.

- **The Committee judged a continuation of a gradual and measured policy normalization to remain appropriate, while standing ready to adjust the size and timing of policy normalization should the evolving growth and inflation outlook differ from the current assessment.** Although inflation has declined, upside risks remained from both demand and supply factors, including from future government policies. A gradual increase in the policy rate would help contain upside risks to inflation and anchor inflation expectations more effectively than raising the policy rate only after price-setting behavior have changed. Meanwhile, the Committee would continue to closely monitor the impact of higher interest rates, particularly on vulnerable groups.

<u>Monetary policy decision</u>

The Committee voted unanimously to raise the policy interest rate by 0.25 percentage point from 1.75 to 2.0 percent.

The Committee expected a continued economic expansion, driven mainly by tourism and private consumption. Merchandise exports are expected to recover gradually. **Although headline inflation slowed, core inflation remained elevated.** Furthermore, inflationary risks stemmed from greater demand pressures from expanding economic activities and higher cost pass-through from supply pressures. **Financial conditions turned less accommodative.** Nevertheless, overall conditions remained supportive of the mobilization of funds by the private sector and the ongoing economic recovery. **The overall financial system remained resilient.** Debt serviceability of businesses and households improved in line with the economic recovery. As for some fragile SMEs and households, the Committee encouraged a continuation of debt restructuring and emphasized on the importance of having targeted measures and sustainable debt resolution for vulnerable groups.

Under the prevailing monetary policy framework, the Committee would seek to maintain price stability, support sustainable growth in line with potential, and preserve financial stability. In view of these objectives, the Committee expected a steady economic expansion but saw a need to monitor upside risks to inflation. **The Committee thus decided to increase the policy interest rate to normalize the monetary policy stance in a gradual and measured manner toward a level consistent with long-term sustainable growth. The Committee would be prepared to adjust the size and timing of policy normalization should the evolving growth and inflation outlook differ from the current assessment.**

Monetary Policy Group

14 June 2023