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SCB Securities Company Limited

EIC sees higher chance of a policy rate cut this year after the MPC voted to hold the rate in split vote

5 August 2021

Key summary

- **The Monetary policy committee (MPC) voted 4 to 2 to maintain the policy rate at 0.50 percent. Althought the MPC assessed that the Thai economy would be affected by the COVID-19 outbreak more than expected as reflected by the downward revision of the growth forecast this year to 0.7% and next year to 3.7% (from previously 1.8% and 3.9% respectively), most members expected that financial measures would be more effective than a further reduction in the policy rate which was already low. Meanwhile, two members voted to cut the policy rate 0.25% to shore up the economy and mitigate heightened risks in the period ahead.**
- **The MPC assessed that liquidity in the financial system remained ample but its distribution was still uneven due to increased credit risks, particularly among SMEs and households. Moreover, the Thai economy would face significant downside risks which could affect private consumption, income, and employment.**
- **EIC assesses that the MPC would maintain the policy rate at 0.50% for the rest of 2021 and also in 2022. If the economy appears to be in line with the baseline forecast of the lastest MPC assessment such that the outbreak would be contained within the fourth quarter of this year, the MPC will likely decide to keep the policy rate on hold in order to preserve the policy space and will focus on adjusting financial measures a more efficient liquidity distribution. However, there is higher chance of a policy rate cut this year (probability of 30%) due to downside risks from Delta varient outbreak amid slow vaccination progress which could cause the outbreak and lockdown measures to prolong for longer that expected. This will have a larger impact on the recovery and economic scars, and may thus lead the MPC to cut the policy rate by 0.25% this year in order to shore up the economy. Nevertheless, issues to be monitored include containment of the outbreak, vaccine development, and adequacy of fiscal measures.**
- **Overall, EIC expects the policy rate cut to help reduce debt burden to some extext, but the benefit in stimulating the economy will largely be limited amid a very low policy rate. Whereas, the economy was affected by falling income mainly as a result of lockdown measures and concerns on the outbreak. Accelerating vaccination progress to contain the spread, fiscal stimulus to compensate the income loss, and adjusting financial measures for widespread liquidity distribution would better address the problems.**
- **EIC assesses that public sector will consider adjusting the implemented financial measures and may implement additional measures to expedite liquidty distribution and reduce debt burden for the affected groups more efficiently according to the MPC communication. For the special loan facility and**

asset warehousing scheme, there may be adjustments on loan conditions and restrictions, particularly regarding credit risk mitigation and cost reduction for SMEs affected the outbreak. This will help enchance credit access for SMEs that despite some improvement, liquidity had yet to be evenly and sufficiently distributed.

- On financial market, financial conditions remain accommodative as the Thai government bond yields declined in the previous month in line with US treasury yields. Meanwhile, the baht weakned relatively more than other regional currencies given concerns over the outbreak situation and persistent current account deficit.

Key points

The MPC revised down the ecnomic growth forecast as impacts from the outbreak were larger than expected but voted 4 to 2 to maintain the policy rate at 0.50%. Most members viewed that financial measures would be more effective than the policy rate cut, while 2 members voted to cut the policy rate by 0.25% to shore up the economy. The MPC assessed that the Thai economy in 2021 would be affected by the COVID-19 outbreak more than expected with significant downside risks. The most important issue for the Thai economy at present was to accelerate containment of the outbreak and distribution of vaccines to restore confidence and support the recovery in economic activities and income. Fiscal and financial measures must be expedited to assist affected groups in a more targeted and timely manner. The MPC viewed that risks to the economic outlook remained high. The support must be provided by accelerating the distribution of liquidity and reduce debt burden for those who were affected. Most members viewed that financial measures would be more effective than a further reduction in the policy rate which was already low. Most members thus voted to maintain the policy rate. Nevertheless, two members voted to cut the policy rate to support other measures in shoring up the economy and mitigate heightened risks in the period ahead.

- **The Thai economy was projected to expand 0.7 and 3.7 percent in 2021 and 2022 respectively.** This lower projection was due to a more prolonged and severe impacts of COVID-19 outbreak than expected. Also, private consumption was greatly affected this year and foreign tourist figures were expected to be significantly lower next year due to delayed country re-opening and lower confidence among foreign tourists. The Bank of Thailand (BOT) thus revised down forecast of foreign tourist figures to 0.15 million persons in 2021 and 6 million persons in 2022 (from 0.7 million persons and 10 million persons respectively).
- **The labor market would be more fragile** due to the third wave outbreak, especially the services sector and self-employed. In the second quarter of 2021, there were a rise in underemployement for the first time in a year, an increase in labor migration back to their home provinces, and an acceleration of long-term unemployment. In addition, recovery of private non-farm employment would be W-shaped, while the more severe and prolonged outbreak will make recovery longer looking forward. However, the Thai economy would be supported by higher public expenditure thanks to the lastest Emergency Decree and improving

merchandise exports, although parts of the manufacturing sector were affected by the outbreak in factories and temporary shortages in raw material.

- **Headline inflation would be largely unchanged**, while medium-term inflation expectations remained anchored within the target.
- **Downside risks to the economic outlook remained significant from the possibility of the outbreak situation in Thailand and other countries becoming more severe.** The MPC would closely monitor these risks which would affect private consumption as well as income and employment in addition to impacts on foreign tourist figures.

The MPC assessed that liquidity in the financial system remained ample but its distribution was still uneven due to increased credit risks, particularly among SMEs and households that were additionally impacted by the outbreak. Nonetheless, the special loan facility for businesses helped enhance credit access for SMEs. On exchange rates, the Thai baht relative to the US dollar depreciated more than regional currencies owing to domestic factors.

The MPC noted that the government measures and policy coordination among government agencies would be critical to support the economic recovery. Public health measures should aim at accelerating the procurement and distribution of effective vaccines to prevent the outbreak from being prolonged. Fiscal measures should help alleviate the adverse impacts and support the economy by more actively addressing vulnerabilities in the labor market and business sector in an adequate and timely manner. Monetary policy must contribute to continued accommodative financial conditions overall. Financial and credit measures should be adjusted quickly to enhance effectiveness in order to expedite the distribution of liquidity to the affected groups in a targeted manner and help reduce debt burden. These measures included the special loan facility, asset warehousing scheme, and other measures by specialized financial institutions (SFIs). In addition, financial institutions should accelerate debt restructuring to have broader impacts and be consistent with borrowers' long-term debt serviceability.

The MPC continued to put emphasis on supporting the economic recovery under the monetary policy framework with objectives of maintaining price stability, supporting sustainable and full-potential economic growth, and preserving financial stability. In addition, the MPC would monitor key factors affecting the economic outlook, namely the distribution and efficacy of COVID-19 vaccines, the outbreak situation in Thailand and abroad, as well as the adequacy of fiscal, financial, and credit measures. The MPC would stand ready to use additional appropriate monetary policy tools if necessary.

Implications

EIC expects BOT to keep the policy rate on hold at 0.50% for the rest of 2021 and also in 2022 but the probability for a policy rate cut this year becomes higher. EIC assesses that in the baseline case, the MPC will likely maintain the policy rate at the historically low level until end of 2022. According to the MPC lastest growth projection, the baseline case assumes that the outbreak situation is expected to improve and the lockdown measures can be relaxed within the fourth quarter of this year. The need for a further policy rate cut this year will thus be lower. Moreover, most members still view that the benefit from a policy rate cut at this current juncture would be limited. The key problem is a widespread liquidity distribution to SMEs and households rather than financing costs. In addition, the MPC must carefully weigh against consequences of cutting the policy rate to be nearer to zero. Such consequences include 1) a lower policy rate may cause some groups of people mainly relying on interest income from deposits such as the elderly to save more and cut spending, 2) a policy space will be lower and not sufficient to accommodate the worse case of the economic outlook, and 3) a policy rate cut to very low level may induce large debt creation, resulting in difficulties to raise policy rate in the future. This could increase risk to financial stability in the long run due to elevated debt levels, search-for-yield behavior, and the underpricing of risk.

However, downside risks to the economic outlook remain significant, particularly due to potentially prolonged outbreak than expected, will increase the probability of another policy rate cut this year (approximately 30%). This is because Delta variant has higher transmission rate compared to other variants, especially in the situation where vaccination rate is still low. As a result, the current lockdown measures may not be sufficiently effective in containing the spread within the fourth quarter of this year as the baseline case. If downside risks were to occur, be they a more severe and prolongered outbreak than expected, a more severe impact of the lockdown measures on private consumption and investment than previously assessed, or smaller government support than expected, most members might see a need to lower the policy rate further. This is in order to shore up the economy by reducing debt burden and supporting debt restructuring for households and SMEs. Lower policy rate will also prompt financial conditions to be more accommodative and help reduce government interest burden from potentially rising public debt in the periods ahead. Nevertheless, in addition to the policy rate cut, the MPC may consider extending the period of FIDF contribution reduction implemented last year, or consider reducing contribution rate further.

BOT will adjust the implemented financial measures and may issue additional measures to expedite liquidity distribution to those affected by the outbreak in order to ensure more widespread and sufficient distribution as communicated by the MPC. Although, BOT has coorporated with related agencies in adjusting financial measures to more efficiently assist SMEs, including special loan facility and asset warehousing scheme, the progress of such meausres has been slow and liquidity distribution is still uneven. As of July 27, 2021, 27,219 businesses received loans under the special loan facility, accounting only 3.5% of SMEs registered as juristic entities in Thailand totaling around 0.77 million. Moreover, loans approved under this facility only accounts 82 billion baht from the total credit line of 250 billon baht. There is thus a high probability that SME loans could continuously contract this year. As for the asset warehousing scheme, there were also few participants with only 18 businesses admitting to the scheme. This reflects that the scheme conditions and regulations of relevant agencies remain obstacles for businesses to be admitted into the scheme. This will be a key challenge for the public sector to accelerate adjustment on the conditions and reduce obstacles in order to enhance effectiveness in liquidity distribution. For the special loan facility for SME, the public sector may consider mechanism to increase participation and reduce credit risks, including reducing TCG's credit guarantee fee, increasing compensation rate for loan portfolios, or announcing that the government will absorp sufficiently high risk exposure in the form of loan guarantee. This will ensure liquidity distribution to SMEs severely affected by the COVID-19 crisis.

On financial market, financial conditions remain accommodative due to lower Thai government bond yields in the previous month in line with US treasury yields, as well as domestic factors. 10-year Thai government bond yield stood at 1.53%, down 21 bps from the beginning of July, while 10-year US treasury yields recorded 1.18%, down 28 bps during the same period (Figure 1).

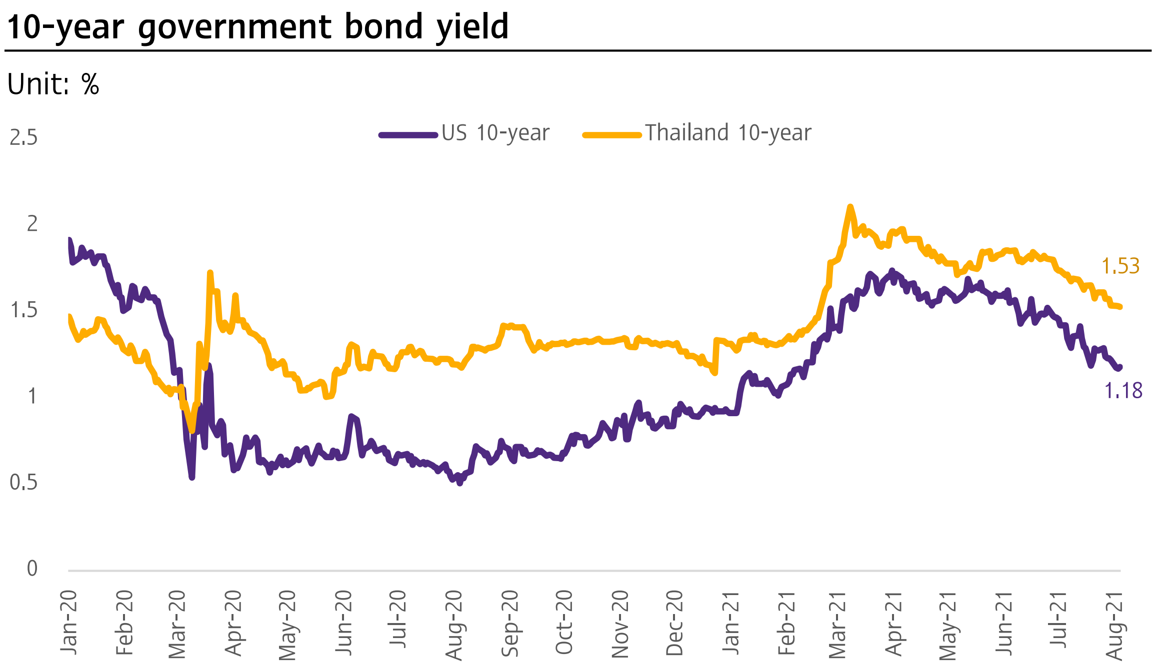
US treasury yields declined continuously in July 2021. The decline was in contrary to the US economic data outturns including non-farms payrolls and inflation that continued to rise. Nevertheless, the decrease in US treasury yields was due to the following 3 factors;

1) **Concerns on the economic impact caused by Delta-variant COVID-19 outbreak,** where the number of daily new infections in the US as well as the number of new hospital admissions accelerated fast over the past week, most of which are those that have not been vaccinated. The resurgence of the COVID-19 outbreak increased concerns among investors regarding uncertain economic outlook, causing them to avoid holding risky assets and invest more on safe assets.
2) **Lower market expectation regarding the possibility of US monetary policy tightening**, where the latest US policy rate forecast was lower than the forecast in June (Figure 2). This reflects that the market lowered expectation on the possibility to raise interest rate. Moreover, investors also lower medium-term inflation expectations, viewing that the recent acceleration of inflation was due to temporary factors. This is contrary to the view in the first quarter that investors view that inflation will likely remain high owing to US large economic stimulus package and rapid vaccine distribution.
3) **Supply-side constraints will become more severe and prolonged than assessed.** This is considered key risk to the global economy including the US economy in the period ahead. Delay in manufacturing sector and low investory levels will result in longer delivery times and put upward pressures on price, while many factories around the world had to temporary pause operations. Moreover, US labor market has not yet recovered to the pre-Covid level while the employment benefits[1] will start to expire in some states.

Thai government bond yields declined in line with the US treasury yields and domestic factors. Domestic outbreak and implementation of stricter lockdown measures worsened the economic outlook, resulting in deteriorating confidence of investors and putting additional pressures for the Thai government bond yields to fall further.

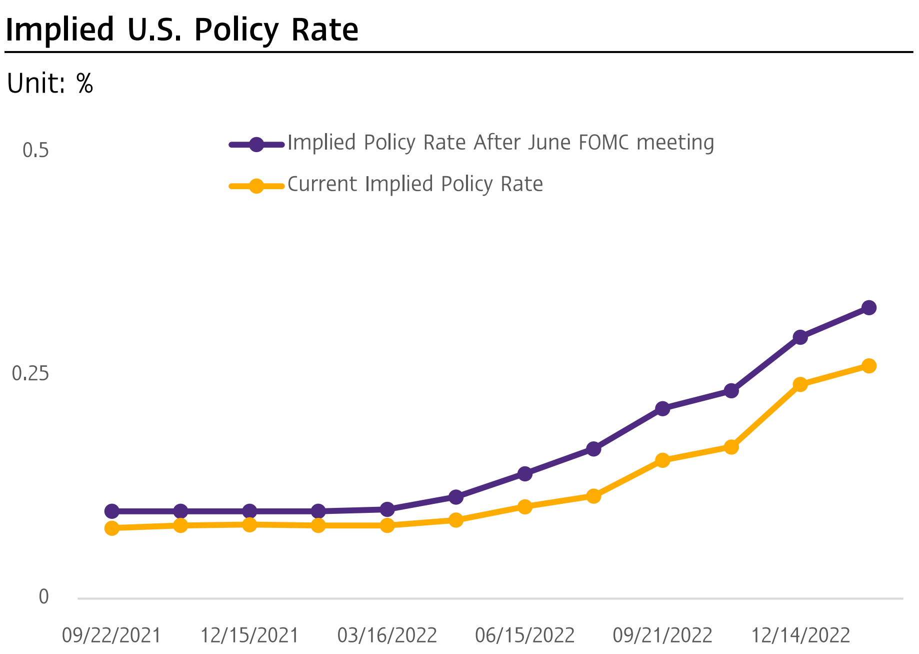
[1] Unemployment compensation

Figure 1: Financial conditions remain accommodative due to lower Thai government bond yields.



Source: EIC analysis based on data from Bloomberg

Figure 2: Investors has lowered their expectations on the policy rate hike.



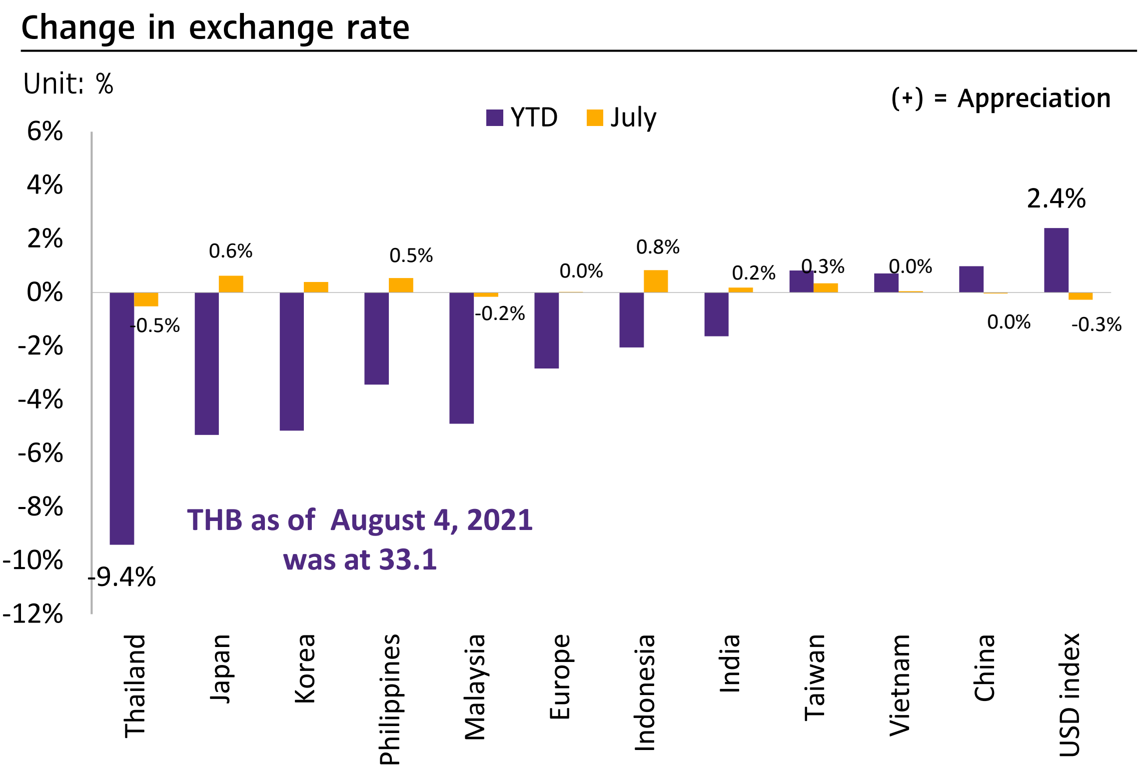
Source: EIC analysis based on data from Bloomberg

The baht weakned relatively more than other regional currencies given concerns over the outbreak situation and persistent current account deficit. The baht recorded 33.1 baht per USD, weakened 9.4% from the beginning of the year, as the baht depreciated relatively greater than other regional currencies. (Figure 3) In the short run, the baht is likely to remain weak for the following reasons.

1. **Delta-variant COVID-19 outbreak that became more prolonged and severe** affected confidence of investors, causing outflows from the Thai financial markets in July from both bond and equity markets. Concerns on the outbreak in many countries induced investors to buy more USD, resulting in USD appreciation against other currencies.
2. **Thailand's current account deficits continue to persist.** In the second quarter of this year, Thailand's current account recorded a deficit of THB 164 billion, the lowest level since 2013. This was primarily due to service account deficit owing to rising transporation costs, particularly freight costs. Meanwhile, trade balance still registered a surplus. Moreover, stagnant tourism which caused demand for the baht to fall resulted in fast depreciation of the baht.

However, should the outbreak situation improve in the fourth quarter this year, this will be a factor for the baht to strengthen slightly toward the end of the year. If the fright costs that have increased in earlier periods on account of supply chain disruption alleviate during the rest of the year, deficit in service account will lower. Moreover, if the government is able to contain the outbreak and restore investor confidence, demand for the baht will increase, causing the baht to appreciate. EIC expects the baht to be in the range of 32.5-33 baht per USD.

Figure 3: The baht weakned relatively more than other regional currencies given concerns over the outbreak situation and persistent current account deficit.



Source: EIC analysis based on data from Bloomberg

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