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FLASH

SCB Economic Intelligence Center

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10 February 2022

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KEY SUMMARY

The MPC voted unanimously to maintain the policy rate at 0.5%.

The MPC assessed that the Thai economy in 2021 would expand faster than previously projected, and the recovery would continue into 2022 driven by higher merchandise exports, as well as a higher number of foreign tourist arrivals due to faster-than-expected relaxation of travel restrictions. Headline inflation would accelerate in early 2022 owing to the rises in energy and raw food prices with increased upside risks. Meanwhile, demand-side inflationary pressures remained subdued in line with the gradual recovery of household income and purchasing power. Nevertheless, the average inflation rate for the full year 2022 and medium-term inflation expectations would remain within the target range. Furthermore, there had not been an indication of broad-based increases in the prices of goods and services.

EIC expects the Federal Reserve (Fed) to speed up policy tightening.

This is because the US economy has exhibited continuous recovery in the previous year as reflected by unemployment rate that dropped to the level close to pre-COVID level and inflation that accelerated to the highest rate in 39 years from both strong demand and supply shortages. As a result, EIC expects that the Fed may raise policy rate 5 times this year with the terminal Fed funds rate hovering around 2.5-2.75% in 2024-2025. The Fed may also begin the Quantitative tightening (QT) in the middle of this year, where this QT will likely start earlier and with twice the volume than the previous one. This will cause liquidity in the financial system to decline and long-term US treasury yields to slightly increase.

Furthermore, the US dollar will likely strengthen, leading capital inflows to emerging markets to slow down from the previous year, especially in the first half of the year where outflows are expected in some periods. Countries with fragile external stability may face higher risk of capital outflows than those with strong external stability. Some central banks may thus see a need to raise policy rate to slow capital outflows, preventing their currencies from depreciating too quickly.

EIC expects that the MPC will not quickly raise the policy rate following the Fed's hike.

This is due to the following reasons: 1) the Thai economic recovery is much slower than the US and Thailand's inflation is also lower and driven mainly by an increase in energy prices, while demand-pull inflationary and wage pressures remain low. 2) Thailand's external stability remains sound, providing Thailand a buffer against pressure from capital outflows. 3) Share of foreign investment in the Thai financial markets is limited and lower than that of regional peers, resulting in low risk of capital flight. 4) Although the Thai government bond yields will likely edge up in line with US treasury yields, the increase is expected to be small as liquidity in the Thai financial system remains ample. Moreover, 90% of the private sector's financing is borrowing through financial institutions. Therefore, most businesses especially SMEs will not be affected much. Furthermore, Thailand's stock market has large share of cyclical stocks that will benefit from the recovery. Thus, capital outflows from Thailand's stock market will not be extreme.

EIC expects the MPC to maintain the policy rate at 0.5% throughout 2022.

The first policy rate hike can possibly occur in 2023 when the Thai economy returns to the pre-COVID levels. Moreover, the peak of the Thai policy rate in this interest rate upcycle will be around 2.25-2.50%, lower than the previous cycle. This is because household, corporate, and public debts are all higher than the past. A policy rate increase will thus affect the outlook of consumption and investment more than in the past. Meanwhile, liquidity in the financial system will likely remain high given potentially larger savings-investment gap in line with the aging society trend. This will cause the average policy rate to decline from the past.

Accelerating inflation will not influence the MPC to raise policy rate but will be a risk to the economic recovery.

Thailand's inflation accelerated mainly due to supply-side factors given increases in energy and raw food prices, while demand pressures remain low. EIC expects that energy prices will likely remain high throughout the year driven by both global energy prices and the government's tendency to gradually reduce energy subsidies for both LPG and electricity. There is also a possibility of raising the price cap on diesel fuel in line with rising fiscal constraints. These factors are key risks that will cause inflation to accelerate faster than the previous forecast amid labor market that has yet to fully recover and wages that can't keep up with rising inflation during the COVID-19 outbreak. Therefore, EIC views that this cost-push inflation will put pressure on the economic recovery, particularly for households with falling real income which affects purchasing power. Meanwhile, businesses will be unable to fully passthrough the rising costs and will see falling profit margin. EIC thus expects the MPC to keep the policy rate steady at this current level throughout this year in order to support the economic recovery before considering to hike the policy rate to preserve price stability in the period ahead.

KEY POINTS

The MPC voted unanimously to maintain the policy rate at 0.5%, assessing that the Thai economy would continue to recovery this year on the back of exports and tourism recovery. At the Monetary Policy Committee (MPC) meeting on February 9, 2022, the MPC voted unanimously to maintain the policy rate at 0.5%. The Committee assessed that the Thai economy would continue to recover, as the Omicron variant would exert limited pressure on the public health system. Downside risk to growth improved. However, there remained a need to closely monitor developments of the pandemic going forward. Upside inflationary risks increased, and headline inflation would accelerate in early 2022 owing to the rises in energy and raw food prices. While demand-side inflationary pressures remained subdued in line with the gradual recovery of household income, there remained a need to monitor global energy prices and broad-based cost pass-through to goods and services. The Committee viewed that the continued accommodative monetary policy would help support economic growth, and thus voted to maintain the policy rate. In addition, the ongoing financial and fiscal measures, with the focus on rebuilding and enhancing potential growth, would play an important part in bolstering the robust recovery of the labor market as well as the income of businesses and households.

- **The Thai economy in 2021 would expand faster than previously projected, and the recovery would continue into 2022** driven by higher merchandise exports, as well as a higher number of foreign tourist arrivals due to faster-than-expected relaxation of travel restrictions. However, the recovery would remain fragile and uneven across sectors, especially in tourism which was below pre-pandemic levels. The Committee would monitor developments of the labor market as well as the impact of higher living costs given that income had not fully recovered.
- **Headline inflation in 2022 would be higher than previously assessed and could exceed the target range in the early part of the year.** This would be owing to price increases in certain sectors, especially energy and raw food products. Meanwhile, upside risks to inflation increased. In particular, cost pass-through from producers to consumer prices could increase if energy and raw food prices remain elevated for longer than expected, or if the supply constraint problems broaden into other goods. Nevertheless, the average inflation rate for the full year 2022 and medium-term inflation expectations would remain within the target range. Furthermore, there had not been an indication of broad-based increases in the prices of goods and services, where the proportion of domestic goods and services with above-average prices was small (below 10%) compared to the US at 35%. Meanwhile, demand-side inflationary pressures remained subdued. In the period ahead, there remained a need to closely monitor developments of global energy prices and domestic goods and services prices, as well as the possibility of growing wage pressures.

The MPC assessed that overall liquidity remained ample, but liquidity distribution still varied across economic sectors. Long-term Thai government bond yields rose primarily in tandem with US Treasury yields. On exchange rates, the baht relative to the US dollar still exhibited volatile movements due to faster monetary policy normalization in advanced economies and the easing of domestic outbreak containment measures. The Committee would closely monitor developments in both global and domestic financial markets, and continue to expedite the new foreign exchange ecosystem, particularly through supporting SMEs in hedging against risks from exchange rate volatility.

The MPC cited that the government measures and policy coordination among government agencies would be critical to support the economic recovery. Public health measures should strike a balance between containing the outbreak and supporting the recovery of economic activities. Fiscal measures should support the economic recovery in a targeted manner, with a focus on generating income and expediting measures to rebuild and enhance potential growth. Monetary policy should contribute to continued accommodative financial conditions overall. Financial and credit measures helped distribute liquidity to the affected groups in a targeted manner and 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 consolidation and debt restructuring in a sustainable manner through the scheme launched on September 3, 2021 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. The MPC would closely monitor key factors affecting the economic outlook, namely, developments of the COVID-19 outbreak, global energy prices, higher cost pass-through, as well as the adequacy of fiscal, financial, and credit measures. The Committee would stand ready to use appropriate monetary policy tools if necessary.

IMPLICATIONS

EIC expects the Fed to begin its monetary policy tightening at the next meeting in March given that the US economy has continuously recovered while inflation has accelerated to the highest rate in 39 years. US unemployment rate has continued to decline from the COVID-19 period to 3.9% in December 2021, despite a slight increase in January due to the Omicron outbreak. Unemployment is however expected to continue falling in 2022. The economic recovery coupled with higher energy prices, and supply shortages of certain products caused US inflation to soar to its record high (headline inflation accelerated to 7% in December). EIC thus expects the Fed to raise policy rate 5 times this year with the terminal Fed funds rate hovering around 2.5-2.75% in 2024-2025. The Fed may also begin the Quantitative tightening (QT) in the middle of this year, where this QT will likely start earlier and with twice the volume than the previous one. The Fed may cut its balance sheet by around 15% of GDP (from currently USD 8.8 trillion to USD 6.1-6.6 trillion in 2-2.5 years).

The Fed's monetary policy tightening will be a key factor contributing to tightening global financial conditions and influencing some central banks in emerging markets to raise their policy rates. The potentially falling liquidity in the financial system may cause long-term US treasury yields to increase slightly (EIC expects the rise to 2.1% by 2022). Moreover, the US dollar is likely to strengthen in line with the outlook of policy rate hike and quantitative tightening of the Fed, causing capital to flow back to the US while capital inflows to emerging markets (EMs) will slow from the previous year. Countries with fragile external stability may face higher risk of capital outflows than those with strong external stability. Some central banks may thus see a need to raise policy rate to slow capital outflows, preventing their currencies from depreciating too quickly. For example, Brazil raised its policy rate from 2% in January 2021 to 10.75%, while Russia raised the policy rate from 4.25% to 8.5% during the same period. South Korea increased its policy rate in August 2021 from 0.5% to 1.25% in line with rising inflationary pressures.

However, EIC sees no need for the MPC to quickly raise the policy rate following the Fed's hike due to the following reasons.

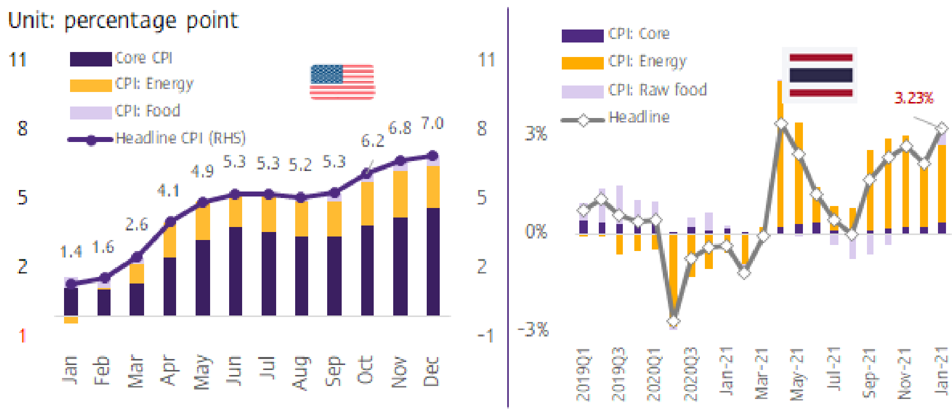
1) Thailand and the US have large differences in the economic recovery and inflationary pressures. The US GDP growth in 2021 is as high as 5.7%, while Thailand's GDP growth is expected to register only 1.1%. In addition, US inflation accelerated driven by strong demand following the city reopening, high energy prices, and supply shortages in certain products. However, Thailand's inflation in January rose to its highest rate in 9 months at 3.23% with the increase largely coming from rising costs from the supply side. Meanwhile, core inflation, which reflects demand-pull inflationary pressures and risk of growing wage pressures, remains low (Figure 1). Moreover, US labor market has recovered rapidly to the level close the pre-COVID level, while Thai labor market remains fragile with unemployment rate in 2021 at 1.9%, higher than pre-COVID level at 1% in 2019.

Figure 1: Thailand and the US have large differences in the economic recovery and inflationary pressures.

Economic data of Thailand and U.S.

	Indicator	Thailand	US
Growth	Real GDP growth	2020 -6.1%yoy 2021E 1.1%yoy	2020 -3.4%yoy 2021 5.7%yoy
Inflation	Headline CPI Inflation Core CPI Inflation	Jan 2022 3.2%yoy 0.5%yoy	Dec 2021 7%yoy Core PCE 4.9%yoy
Labor	Unemployment	Pre-COVID (2019) 1% 2021 1.9%	Pre-COVID (2019) 3.6% 2021 4.2%

Comparison of inflation in Thailand and U.S.



Source: EIC analysis based on data from Bloomberg and the Bank of Thailand

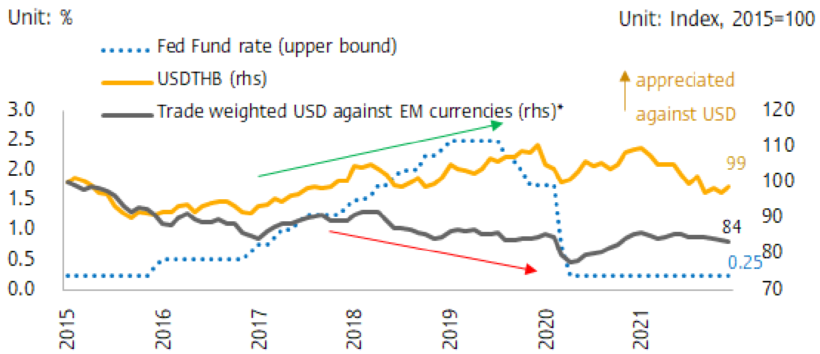
2) **Thailand's external stability remains sound, providing Thailand a buffer against pressure from capital outflows.** Thailand's international reserves are the 12th highest in the world, providing Bank of Thailand (BOT) a tool to cope with capital flow volatilities. Meanwhile, Thailand's external debt to GDP remains low. However, despite Thailand's current account deficit in 2021 (first deficit since 2014), the current account is likely to improve this year and is expected to register a surplus in 2023 in line with tourism recovery. Strong external stability will offer Thailand a buffer against volatilities in capital flows and financial markets. This was evident in the past events during 2015-2018 when the US raised its policy rate totalling 9 times (from 0.125% to 2.375%), causing emerging markets' currencies to weaken 8%. However, the baht continued to appreciate by nearly 10% over three years, although during that period the BOT has kept the policy rate steady at 1.5% until 2018 (Figure 2). This was a result of strong external stability.

Figure 2: Strong external stability provided Thailand a buffer against volatilities in capital flows and financial markets, as evident by past events during 2015-2018.

Thailand's external stability

	Now	2015-2018 average
External debt	36% of GDP	34.2% of GDP
International reserve	3 times of short-term external debt	2.6 times of short-term external debt
Current account	$-10.9 Billion	$35.9 Billion

U.S tightening cycle and emerging markets' currencies



Note: data of St. Louis Fed calculated by all EM's exchange rate

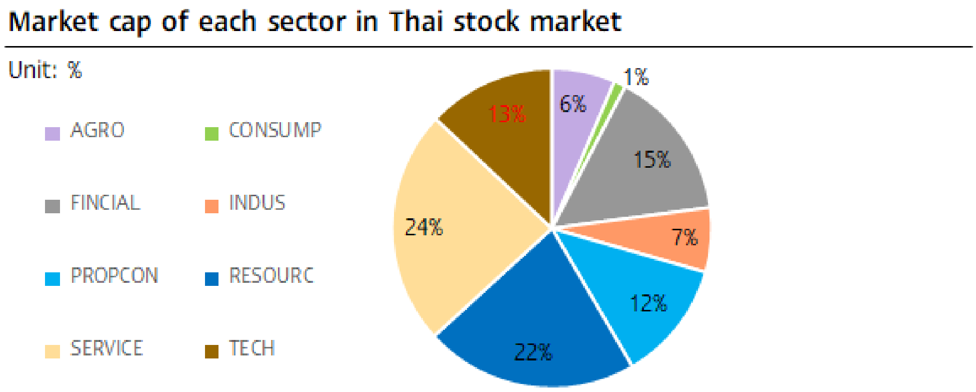
Source: EIC analysis based on data from Bloomberg and FRED

3) **Share of foreign investment in the Thai financial markets is limited and lower than that of regional peers, resulting in low risk of capital flight.** Share of foreign investment in the Thai stock markets accounts for 26% and only 9% in the bond market. These figures are lower than those of regional peers including Indonesia (share of foreign investment is 46% in the stock market and 22% in the bond market), and Malaysia (share of foreign investment is 20% in the stock market and 25% in the bond market). Moreover, Thailand's foreign direct investment (FDI) remains low. Therefore, risk of capital flight is still limited.

4) **Although the Thai government bond yields will likely edge up in line with US treasury yields, the increase is expected to be small as liquidity in the Thai financial system remains ample. Moreover, Thailand's stock market has large share of cyclical stocks. Therefore, capital outflows from Thailand's stock market will not be extreme.** Although the sensivity of Thai government bond yields to government bond yields of G3 has been high at around 80%, Thai government bond yields are expected to slightly increase in tandem in this cycle. This is because liquidity in the Thai financial system remains ample. Moreover, 90% of the private

sector's financing is borrowing through financial institutions. Therefore, most businesses especially SMEs will not be affected much. With regard to the stock market, majority of Thai stocks are cyclical stocks that will likely recover in line with the economy including stocks in energy, banking, real estate, construction, industrial, and services sectors (Figure 3). Thus, capital outflows from Thailand's stock market will not be extreme.

Figure 3: Majority of Thai stocks are cyclical stocks that will likely recover in line with the economy.

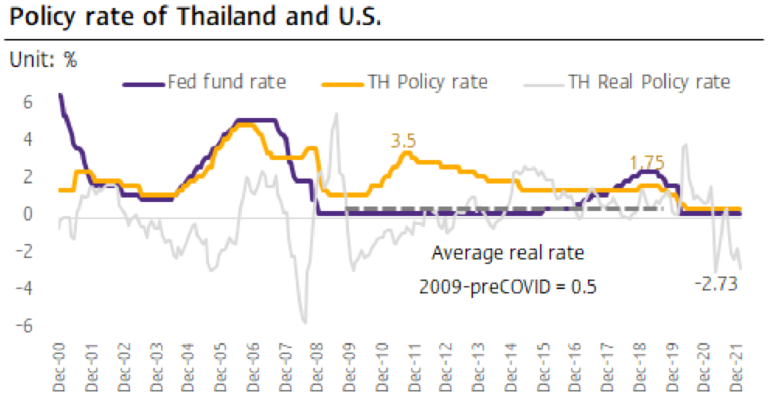


Source: EIC analysis based on data from Setsmart

Therefore, EIC expects the MPC to maintain the policy rate at 0.5% throughout 2022, where the peak of the policy rate for this interest rate upcycle is expected to be lower than in the past. The Thai economy will likely return to the pre-COVID level in 2023. As a result, the first hike can occur as early as 2023. Furthermore, EIC expects the peak of the policy rate for this interest rate upcycle to be around 2%-2.5% as Thailand's real policy rate during 2009 until pre-COVID averages around 0.5% (Figure 4). Therefore, if long-term inflation will stand around 1.5-2% (which is higher than 10-year average inflation at 0.9%), policy rate is expected to be around 2-2.5%. Moreover, EIC assesses that the peak of the Thai policy rate will be slightly lower than that of the US (which is expected to be around 2.5-2.75%) in line with the slower economic recovery with greater risks to the economic growth.

Although Thai policy rate used to hit the historical high of 3.5% in the previous upcycle, the peak of policy rate going forward will likely be below the past cycle. This is because household, corporate, and public debts are all higher than in the past. A policy rate increase will thus affect the outlook of consumption and investment more than in the past. Meanwhile, liquidity in the financial system will likely remain high given potentially larger savings-investment gap in line with the aging society trend. This will cause the average policy rate to decline from the past.

Figure 4: Thailand's real policy rate during 2009 until pre-COVID averages around 0.5%



Source: EIC analysis based on data from Bloomberg

EIC assesses that accelerating inflation will not influence the MPC to raise policy rate at this current juncture, but will be a risk to the economic recovery. Thailand's inflation in January soared to 3.23% mainly due to supply-side factors given an increase in energy prices and raw food prices that accelerated since the end of 2021. EIC expects energy prices to remain high throughout the year given tentions between Russia and the West in the case of Ukraine, oil demand that is expected to gradually rise globally in line with the economic recovery, and investment in fossil fuels that is likely to slow down according to the Net Zero target. Furthermore, there are also government's tendency to gradually reduce energy subsidies for both LPG and electricity, and the possibility of raising the price cap on diesel fuel in line with rising fiscal constraints. These factors are key risks that will cause inflation to accelerate faster than the previous forecast amid labor market that has yet to fully recover and wages that can't keep up with rising inflation during the COVID-19 outbreak. Therefore, EIC views that this cost-push inflation will put pressure on the economic recovery, particularly for households with falling real income which affects purchasing power. Meanwhile, businesses will be unable to fully passthrough the rising costs and will see falling profit margin. EIC thus expects the MPC to keep the policy rate steady at this current level throughout this year in order to support the economic recovery before considering to hike the policy rate to preserve price stability in the period ahead.

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