FLASH

SCB Economic Intelligence Center

EIC expects Thai policy rate to continue rising to 1.25% this year and 2% next year.

28 September 2022

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KEY POINTS

The MPC votes unanimously to raise policy rate by 0.25% from 0.75% to 1.00%.

The Thai economic recovery has continued to gain traction, driven mainly by tourism and private consumption. Headline inflation remains at a high level as cost pass-through has increased in the recent period despite declining commodity prices. The overall growth and inflation outlook is consistent with the previous assessment. The Committee deems that a gradual policy normalization remains an appropriate course for monetary policy and is ready to adjust the size and timing of policy normalization should the growth and inflation outlook shift from the current assessment.

The MPC projects the Thai economy to continue growing at 3.3% and 3.8% in 2022 and 2023, respectively.

Such growth will be driven mainly by tourism and private consumption. The tourism sector recovers faster than expected as the number of foreign tourists continues to rise. Moreover, the economic recovery has become more broad-based, both in terms of business sectors, especially services, and in terms of income distribution. Meanwhile, the slower-than-expected global economy has an impact on Thai exports but would not derail the overall economic recovery.

The MPC expects headline inflation in 2022 and 2023 at 6.3% and 2.6%, respectively.

Headline inflation is expected to decline due to falling global oil prices and gradual easing of supply chain bottlenecks. Core inflation is projected to be at 2.6 percent in 2022 and 2.4 percent in 2023, rising more than previously assessed mainly on the back of higher cost pass-through. Wages have increased in some sectors and areas with labor shortages, but there have not been signs of a broad-based wage increase. Furthermore, demand-side inflationary pressures are limited as the Thai economy is still in a recovery stage. Meanwhile, medium-term inflation expectations remain anchored within the target range. The Committee will continue to closely monitor risks to inflation, especially a potential increase in cost pass-through, should businesses face rising cost pressures from multiple sources simultaneously.

The MPC assesses that overall financial system remains resilient, while overall financial conditions remain accommodative.

Although government bond yields have gradually increased, overall funding costs remain conducive for business financing. Meanwhile, the depreciation of the baht against the US dollar has been rapid and continuous due to the strengthening of the US dollar but has not affected the overall growth and inflation outlook. In addition, debt serviceability of households and businesses has improved in line with the economic recovery. However, SMEs in some sectors have yet to fully recover and some low-income households are still sensitive to the rising living costs. The Committee views that financial institutions should continue to press ahead with debt restructuring and deems it important to have targeted measures and sustainable solutions in place for vulnerable groups.

IMPLICATIONS

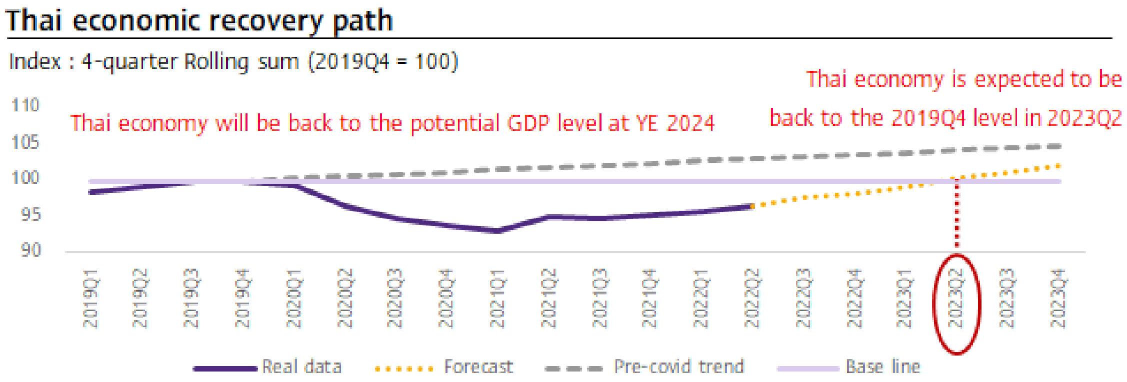
EIC expects Thai policy rate to continue rising to 1.25% at the end of 2022 and 2% at the end of 2023, judging that the MPC will likely hike the policy rate in a gradual manner so as not to derail the economic recovery. Meanwhile, inflationary pressures in the period ahead will likely ease somewhat in line with supply-side pressures including falling commodity prices given demand slowdown, causing inflation to slowly decline. However, it will remain above the target next year due to elevated domestic energy prices and food prices as well as potentially higher cost passthrough to other products. **EIC expects the MPC to raise policy rate 0.25% at the meeting in November 2022, leading policy rate to end the year at 1.25%. For 2023, EIC expects the MPC to hike the rate continuously 3 more times, 0.25% each, to stabilize at 2% at the end of 2023.**

A gradual policy normalization will not hinder the recovery of the Thai economy which is expected to return to pre-covid level during Q2/2023 (Figure 1). However, the Thai economy will remain below its potential for another 1-2 years given deep economic scars and elevated debt levels.

EIC views that the MPC will not need to aggressively hike policy rate like other advanced economies. This is because the Thai economy has just started to recover while demand-side inflationary pressures are not as much as in countries that have previously recovered. Moreover, there remain deep economic scars arising from the COVID-19 situation which affected household debt and income of vulnerable businesses including businesses in services, real estate and construction that are recovering slowly. Given this backdrop, the gradual policy normalization will allow households and vulnerable businesses the time to adjust, and reduce default risks in the period ahead when measures to assist borrowers implemented during COVID-19 (e.g. relaxation of debt classification) expires.

In addition, EIC views that an aggressive hike will not be able to make the baht strengthen against the USD trend, although it will help to reduce pressures on the baht depreciation somewhat in the short run. Moreover, the sharp baht depreciation has not significantly affected the economy and financial markets. Thailand's financial stability remains sound (e.g. capital is not flowing out much while Thai stock market index has not dropped much). Transmission of the impact from baht depreciation to inflation is still limited. Therefore, an aggressive policy rate hike to alleviate pressures from baht depreciation will not worth the risk to the economic recovery.

Figure 1: The Thai economy will return to pre-covid level during Q2/2023



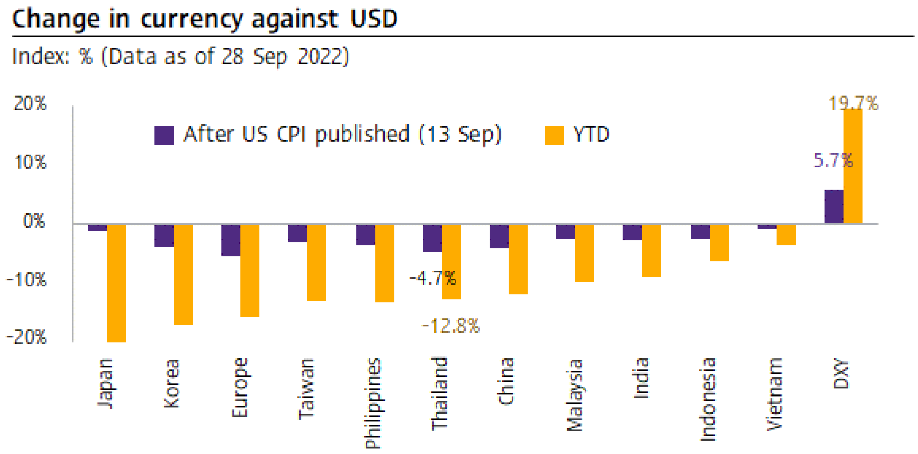
Source: EIC analysis based on data from Bloomberg

The baht has faced large depreciation pressures this month. EIC expects that in the next 1-2 months, the baht will remain volatile in the range of 37.5-38.5 baht per USD. Nevertheless, the baht depreciation is in line with regional currencies (Figure 2) with key driver stemming from the USD strength. The dollar index has strengthened 5% in September due to the followings.

1. **The Fed has signalled that it will continue to raise policy rate throughout this year and next year.** The Median dot plot from the recent FOMC Meeting suggests that the Fed funds rate will register 4.4% at the end of 2022 and 4.6% at the end of 2023 respectively. The Fed has communicated clearly of its commitment to bring inflation back to target of 2% although it could cause the economy and labor market to slow down. Investors thus adjusted their terminal rate expectation upward to 4.6% (from 4.3% since the previous FOMC Meeting). Meanwhile, both short-term and long-term US treasuries edged up to the highest levels in 10 years, causing the dollar index to strengthen to 114 (from 110 before the FOMC Meeting).

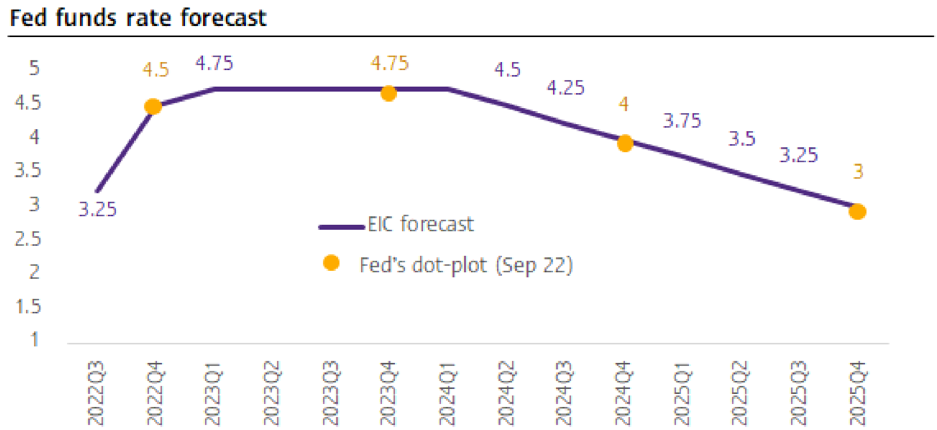
   EIC expects the Fed to raise policy rate 75 bps in November and 50 bps in December, leading the Fed funds rate to end the year at 4.25-4.5% (Figure 3). This is because US inflation is still much higher than the Fed's target of 2%, especially core inflation which continues to accelerate and spread across many categories of goods and services. Also, the US labor market remains strong. **For 2023, EIC expects the Fed funds rate to be raised to the termimal rate at the upper bound of 4.75% in Q1** before being maintained at that level the whole year.

Figure 2: The baht depreciation is in line with regional currencies driven by USD strength



Source: EIC analysis based on data from Bloomberg

Figure 3: EIC expects the Fed to raise policy rate 75 bps in November and 50 bps in December, leading the Fed funds rate to end the year at 4.25-4.5%



Source: EIC analysis based on data from the Fed

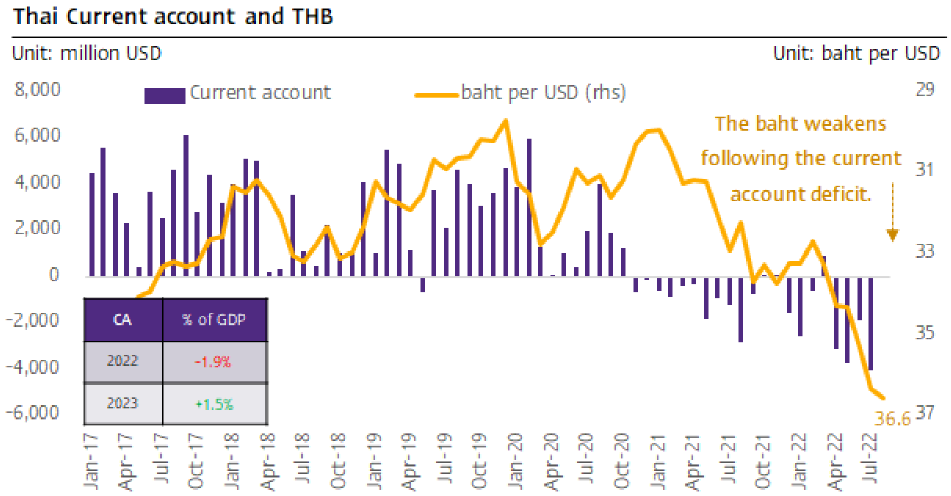
2. **The global economy faced higher risk of global recession** leading to higher demand for safe assets including USD
3. **The Bank of Japan (BOJ) will maintain its accommodative monetary policy** and signalled clearly that it will not raise policy rate in the period ahead, **resulting in weaker JPY against USD.**
4. **Concerns over UK fiscal policy** from the announcement of a tax cut plan to help stimulate the economy could accelerate inflation and necessitate the Bank of England (BOE) to tighten its monetary policy further. Moreover, it could affect fiscal sustainability during the period of rapid interest rate increase, **resulting in the historical weakest GBP against USD.**
5. **The European economy will likely continue to weaken** due to higher natural gas prices, elevated debt problems, as well as political issue in Italy. These pressure the spread between German and

Italian government bond yields to rise, causing concerns over regional fragmentation. This consequently **led to weaker EUR against USD.**

However, EIC expects the baht to strengthen to the range of 36-37 baht per USD during the end of this year and will continue strengthen to 34-35 baht per USD at the end of 2023 propelled by the continuous recovery of Thailand's economic fundamentals as follow.

1. **The Thai economy will likely continue recovering amid slowing global economy** underpinned by tourism and private consumption, while policy rate will be raise in a gradual manner.
2. **Current account is expected to register a surplus during the end of the year** as commodity prices and freight costs have started to ease, and also driven by the recovery of foreign tourist figures and domestic tourism (Figure 4).
3. **Capital inflows are expected into the Thai financial markets** following the Thai economic recovery where valuation of the Thai stocks is still attractive while holdings of foreign investors in Thai stocks are still below historical average (currently at 22%, below 10-year average of 30%)

Figure 4: The baht will likely strengthen as current account is expected to register a surplus at the end of this year



Source: EIC analysis based on data from Bloomberg

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