FLASH

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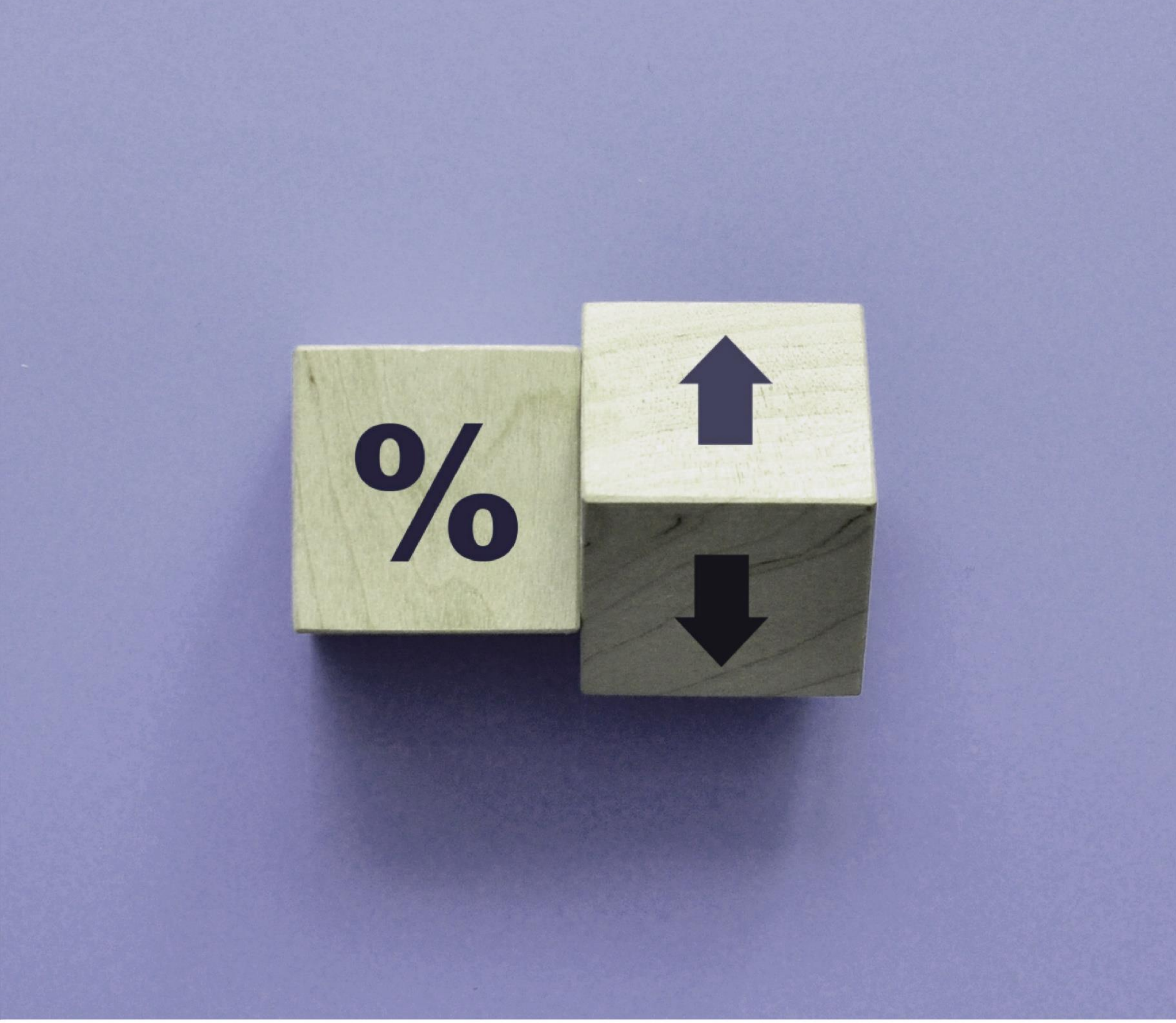

EIC expects MPC to hike rate to 0.75% in Q3

given surge in inflation and improving economic outlook

8 June 2022

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KEY POINTS

MPC voted 4 to 3 to keep the policy rate at 0.5%.

At the Monetary Policy Committee (MPC) meeting on June 8, 2022, the MPC voted 4 to 3 to maintain the policy rate at 0.5%. The Committee assesses that the economy will continue to recover and could expand faster than previously expected owing to stronger domestic demand and the pickup in foreign tourists. Headline inflation would increase and remain elevated for longer than previously estimated, due to the increase in oil prices and higher cost passthrough. The Committee deems that a very accommodative monetary policy will be less needed going forward. Meanwhile, three members voted to increase the policy rate by 0.25% given the economic recovery outlook and upside risks to inflation.

MPC assesses that the Thai economy will expand at 3.3 percent in 2022 and 4.2 percent in 2023.

The upward revision from the previous forecast in March 2022 of 3.2% in 2022 and 4.4% in 2023 is driven by a better-than-expected recovery in domestic consumption, especially in the services sector. Foreign tourist arrivals also improve following the faster relaxation of border controls in Thailand and other countries. Furthermore, the labor market and household income show signs of improvement as economic activities continue to expand in tandem with the relaxation of containment measures. Plus, the impact of COVID-19 and the conflict between Russia and Ukraine on the Thai economy will be limited. However, the Committee will monitor key risk factors to economic recovery, especially the impact of higher living and production costs on private consumption.

MPC projects headline inflation to be 6.2 percent in 2022 and 2.5 percent in 2023.

This is the upward revision from the March 2022 forecast at 4.9% and 1.7%. Inflation will exceed the upper bound of the target range in 2022 due to increasing domestic energy prices and higher cost passthrough that have broadened into wider ranges of products. The rise in inflation has been mainly due to cost-push factors while medium-term inflation expectations remain anchored within the target range. Nonetheless, inflation risks increase significantly from uncertainties surrounding global energy prices, the possibilities of broader and faster cost passthrough, and rising demand-side inflationary pressure as the economic recovery gains strength.

MPC assesses that the economic recovery has continued to gain more traction, while the upside inflationary risks continued to increase.

A very accommodative monetary policy will therefore be less needed going forward. At present, overall financial conditions remain accommodative albeit volatilities increase in financial markets. On exchange rates, the baht has depreciated relative to the US dollar in line with regional currencies. Long-term government bond yields rose in tandem with the monetary policy outlook in advanced economies and the expectation of domestic monetary policy normalization in the period ahead. Meanwhile, liquidity in the financial system remains ample, although liquidity distribution still varies across economic sectors. Moreover, some households and businesses remain vulnerable to rising living and production costs as their incomes have not fully recovered in addition to their high levels of debt.

IMPLICATIONS

EIC expects MPC to hike the policy rate to 0.75% in Q3/2022. The meeting's result reflects the Committee's assessment that the Thai economy will expand faster than expected and inflation will likely increase and remain elevated. The Committee also signalled a policy normalization going forward. **EIC thus expects the MPC to hike the policy rate 25 bps in Q3 in order to reduce the degree of an ultra-easy monetary policy accommodation** on account of the following factors.

1. **Domestic economy will likely improve** as seen from better-than-expected economic outturns in Q1 and private consumption that is expected to recover. Moreover, tourism will continue to expand following the relaxation of border controls. As a result, the Thai economy will recover faster than previously assessed.

2. **Thailand's Inflation will continue to increase and could rise more than expected.** Although the increase in inflation was mainly driven by supply-side factors, inflation will likely remain elevated for the rest of this year. Therefore, the cost passthrough may be larger and faster than expected, affecting household expenses. The BOT assesses that inflation that has risen since the beginning of the year to date has caused household expenses to rise around 850 baht per month (3.6% of income). Meanwhile, the increase in policy rate of 1% will only result in an additional expense of 120 baht per month (0.5% of income). A policy rate hike will thus help ease demand-pull inflationary pressures going forward, thereby reducing inflationary pressures overall.

3. **Real interest rate has declined and Thai baht has weakened rapidly in the recent period.** Higher inflation has led to a decrease in real interest rate (nominal interest rate less inflation). At present, Thailand's real interest rate is relatively lower than that of peers (figure 1), potentially leading to capital outflows from Thailand following a decline in real interest rate. As a result, Thai baht can weaken further. A policy rate hike will help slow capital outflows. Nonetheless, nominal effective exchange rate (NEER) and real effective exchange rate (REER) have not weakened

significantly. Since end of February 2022, NEER and REER only weakened 1% and 1.6% respectively, while the baht has depreciated 4.8% relative to the US dollar (figure 2).

4. **Inflation expectations have started to increase**. Short-term inflation expectation (1-year ahead) of households rose from 2.5% in November 2021 to 3.1% in May 2022. However, long-term inflation expectation remains anchored within the inflation target range of 1-3%, where 5-year ahead inflation expectation records 1.7% (April 2022 survey).

Borrowing costs in the Thai bond markets increased in line with the expectation of domestic monetary policy and global financial market outlook.

Thai government bond yields continue to rise in line with the expectation of Thailand's monetary policy normalization and US treasury yields. Since the beginning of 2022, 2-year Thai government bond yield rose 109 bps to 1.7%, while 10-year Thai government bond yield increased 94 bps to 2.8%. This reflects tighter financial conditions due to higher borrowing costs. This will affect costs of business sector, especially businesses with vulnerable income as domestic economy has yet to fully recover. EIC expects 10-year Thai government bond yield to increase slightly to 3.0-3.1% at the end of 2022 driven by the following factors.

1. **The Fed's accelerating rate hike and tapering** will further give rise to US treasury yields. Moreover, a conflict between Russia and Ukraine will put additional pressure on inflation. EIC expects 10-year US treasury yield to rise to 3.0-3.1% at the end of 2022. 80% of changes in 10-year Thai government bond yield has been in line with that of US treasury yield.

2. **Outlook of the Thai economic recovery in the second half of this year** is expected to improve thanks to domestic demand recovery following city reopening and tourism recovery. This will lead to improvement in foreign tourist figures and boost investor confidence. Therefore, Thai government bond yields will increase.

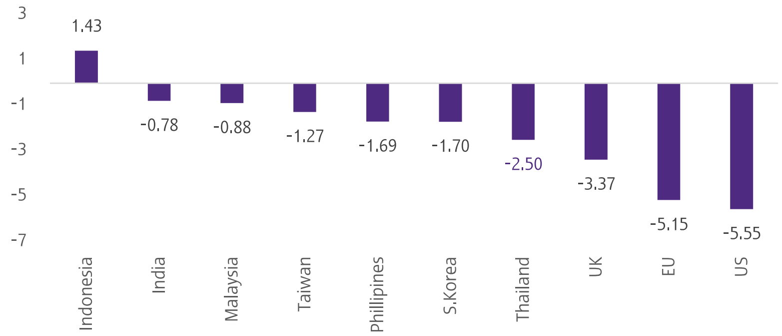
Interest rates in the financial markets will likely increase, causing Thai businesses to accelerate financing through corporate bond issuances in order to lock in lower funding costs.

Given low interest rates in the financial markets and outlook of the Thai economic recovery, the private sector thus accelerated financing through corporate bond issuances. The outstanding value of Thai corporate bonds during January to May 2022 rose 14% from the same period in 2021. EIC views that businesses accelerated financing in order to lock in lower funding costs, which will likely increase in the second half of this year in line with global interest rates and possibility of the policy rate hike by the BOT (figure 3).

Figure 1 : Thailand’s real interest rate is relatively lower than that of regional peers

Real interest rates

Unit: %, Note: calculated by using 12-month average inflation

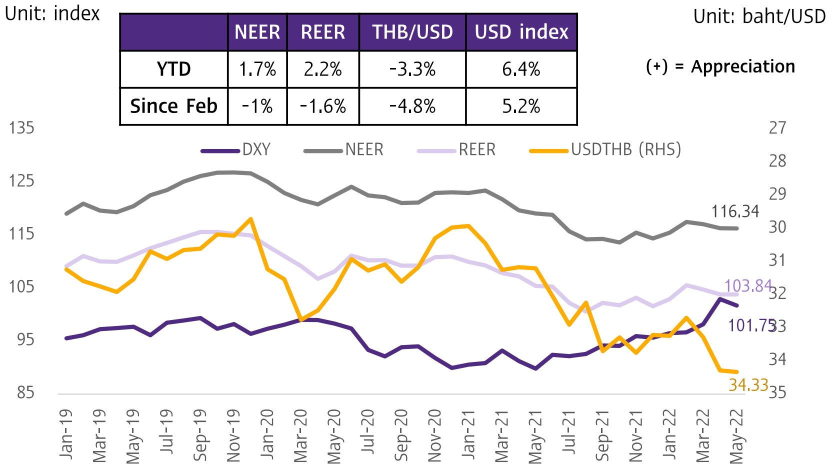


Number of hikes in 2022	Indonesia	India	Malaysia	Taiwan	Philippines	Korea	TH	UK	EU	US
	0 hike 0 bps	2 hike 90 bps	1 hike 25 bps	1 hike 25 bps	1 hike 25 bps	3 hikes 75 bps	0 hike 0 bps	3 hikes 75 bps	0 hike 0 bps	2 hikes 75 bps

Source : EIC analysis based on data from Trading Economics

Figure 2 : Although the baht has weakened rapidly in the recent period, the depreciation has been in line with regional currencies

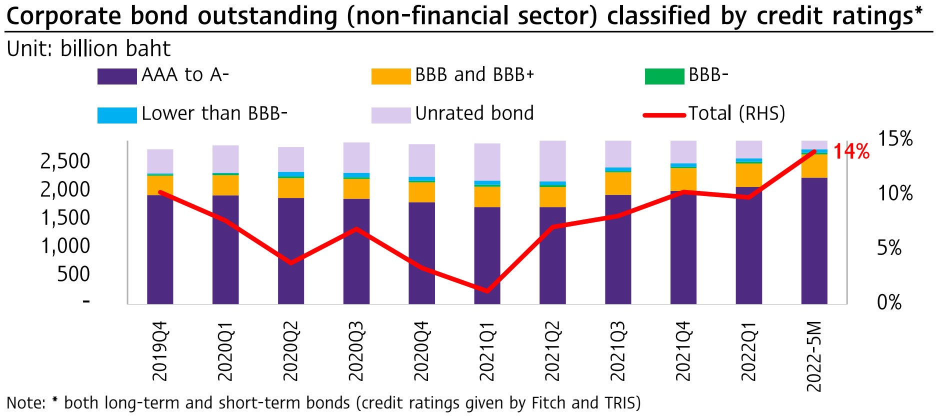
USDTHB NEER REER and Dollar index



	NEER	REER	THB/USD	USD index
YTD	1.7%	2.2%	-3.3%	6.4%
Since Feb	-1%	-1.6%	-4.8%	5.2%

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

Figure 3 : Thai businesses have accelerated corporate bond issuances in the recent period hoping to lock in lower funding costs as some businesses expect interest rates to rise in the second half of this year



Note : *Data includes short-term and long-term corporate bonds, rated by Fitch and Tris.

Source : EIC analysis based on data from ThaiBMA

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