

## 1. Overview

The Thai economy in 2008 Q3 exhibited a decelerating trend, in line with the MPC's assessment in the previous *Inflation Report* (October 2008). However, the slowdown in some components of GDP was larger than expected, particularly net exports. Notwithstanding the fact that the quantity of exports was close to that previously anticipated, the quantity of imports increased markedly. This was likely due to a miscalculation of economic conditions on the part of businesses, resulting in excessive orders of raw materials for production, and thereby leading to unusually high accumulation of inventories. Excluding these excessive inventories, private spending was the only engine of growth in this quarter. However, this driver of growth began to show signs of slowing down, particularly in private investment. Government spending declined compared to the same period in the previous year, signifying that the government's fiscal measures were unable to boost the economy in that period.

Unit: % $\Delta$ yoy	2007	2007		2008		
		Q3	Q4	Q1	Q2	Q3
<b>Domestic demand<sup>1/</sup></b>	<b>2.3</b>	<b>2.9</b>	<b>3.0</b>	<b>3.1</b>	<b>1.7</b>	<b>1.4</b>
Private consumption	1.6	1.9	1.9	2.7	2.5	2.6
Private investment	0.6	1.4	3.8	6.5	4.3	3.5
Public expenditure	6.9	7.4	6.8	0.5	-4.2	-3.9
<b>Net exports of goods and services</b>	<b>21.7</b>	<b>7.9</b>	<b>20.0</b>	<b>4.6</b>	<b>18.3</b>	<b>0.3</b>
Exports of goods and services	7.1	3.8	9.1	8.2	9.1	8.2
Imports of goods and services	3.4	2.7	6.0	9.4	6.9	10.5
<b>Gross domestic product</b>	<b>4.9</b>	<b>5.1</b>	<b>5.7</b>	<b>6.0</b>	<b>5.3</b>	<b>4.0</b>

Note: % $\Delta$ yoy = percentage change from the previous year

<sup>1/</sup>Domestic demand excludes changes in stocks

Source: National Economic and Social Development Board

During the last quarter of 2008, risks to growth increased both from global and domestic factors. The drastic slowdown of the world economy adversely affected exports of Thai goods. Exports, both in terms of value and quantity, began to shrink compared to the same period of the previous year. The same phenomenon was observed in other countries in the region. In addition, political conflicts led to

prolonged protests against the government which continued to intensify, culminating in the closure of two international airports between the end of November and early December. This incident led to a marked decline in the number of tourists during the peak season at the end of the year, and further weakened the fragile confidence of the private sector. Consequently, despite a significant decline in the price pressures given the fall in oil prices, which should have led to reduced production costs, coupled with the continued easing of monetary policy, the rise in the aforementioned negative factors led to a considerable weakening of the Thai economy in 2008 Q4, compared to the assessment in the previous *Report*. Moreover, there was a possibility that the economy would contract compared to the same period in the previous year, partly due to the unexpected contraction of receipts from tourism. As a result, the MPC assessed that the overall economy in 2008 would expand only at approximately 3.6 per cent, much lower than the forecast range of 4.3 - 5.0 per cent provided in the previous *Report*.

Going forward, oil prices were likely to remain at a fairly low level. Inflation should decline markedly, helping to maintain consumers' purchasing power. Accommodative monetary policy, and increased stability in the political situation following the formation of a new government in December 2008 should enable the government's stimulus measures to be more effective. All these factors would support economic growth to some extent. However, the momentum of economic growth in the latter part of the year was softer than expected, coupled with the prospects of major industrial economies which were likely to enter recession and would take some time to recover, and the significant weakening of economies in the region, the Thai economy was expected to expand at a very low rate until the second half of 2009.

The Thai economy in 2010 was expected to recover gradually in tandem with the global economy. Moreover, the effects of the government's stimulus measures in 2009 should help improve confidence and the investment climate, which in turn would stimulate private spending, particularly investment. The recovery of investment and exports, however, would require an increase in imports of capital goods and raw materials. Therefore, imports were expected to expand somewhat during this period, and as a result, the current account was expected to

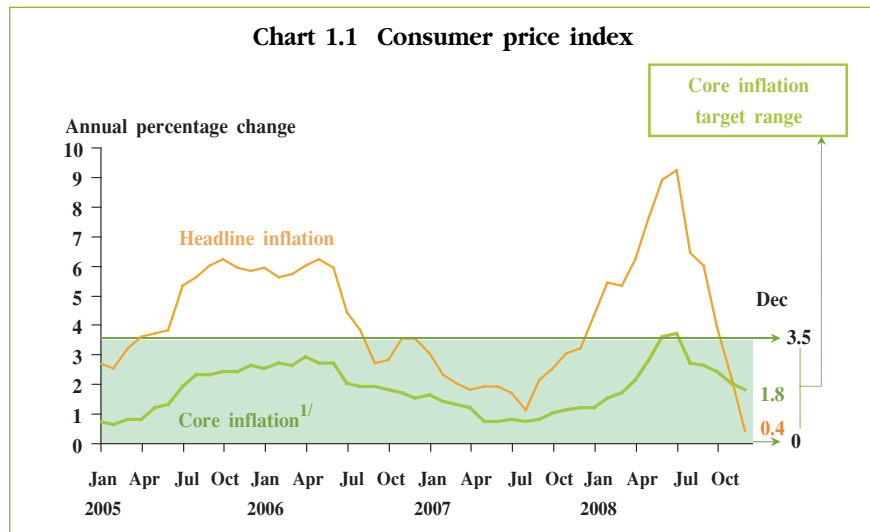
adjust slightly from a small surplus in 2009 to a minimal deficit or a close-to-balance level in 2010.

Given the aforementioned economic conditions and prospects, the MPC adjusted the forecast range for economic growth over the next 8 quarters down somewhat to between 0 - 2 per cent in 2009 and between 2 - 4 per cent in 2010, lower than the forecast in the previous *Report*. Reflecting the downside risks, which outweighed the upside risks, the fan chart is skewed downwards in both years. Crucial downside risks included the possibility of the world economy going into a deep recession for a longer period than assessed in the base case scenario, and a more drawn-out recovery as a result of a prolonged global financial crisis. Moreover, there was also the possibility that the government could not meet the target for budget disbursement to stimulate the economy, especially in the first 2-3 quarters of the 2009 fiscal year due to continued political uncertainty.

The impact of the economic slowdown in previous periods began to affect important sectors of the Thai economy, as reflected in lower business profits, in heightened risks to income and employment of households, as well as an increase in the delinquency rate for household credits - defined as loans 1 - 3 months past due. These fragilities would affect the position of the financial system in the future. As a result, financial institutions tightened their lending standards in line with the elevated risks to economic growth. This meant that the cost of borrowing for the business sector, which included a higher risk premium, was unlikely to decrease substantially, in spite of accommodative monetary policy. Given the fact that cost of funds which incorporated this higher risk premium could erode the ability of the business sector to service debts, the MPC deemed it crucial to closely monitor and assess the consequences of such development on the business sector.

### ***Inflationary outlook and monetary policy***

Price pressures continued to moderate in the second half of 2008, in line with lower oil prices and softer world economic conditions. The pass-through to consumer prices was lower amidst the slowdown of domestic demand. Moreover, the government's temporary measures to alleviate the public's cost of living through the exemption of certain



Note: <sup>1/</sup>Consumer price index excluding raw food and energy items  
 Source: Trade and Economic Index Bureau, Ministry of Commerce

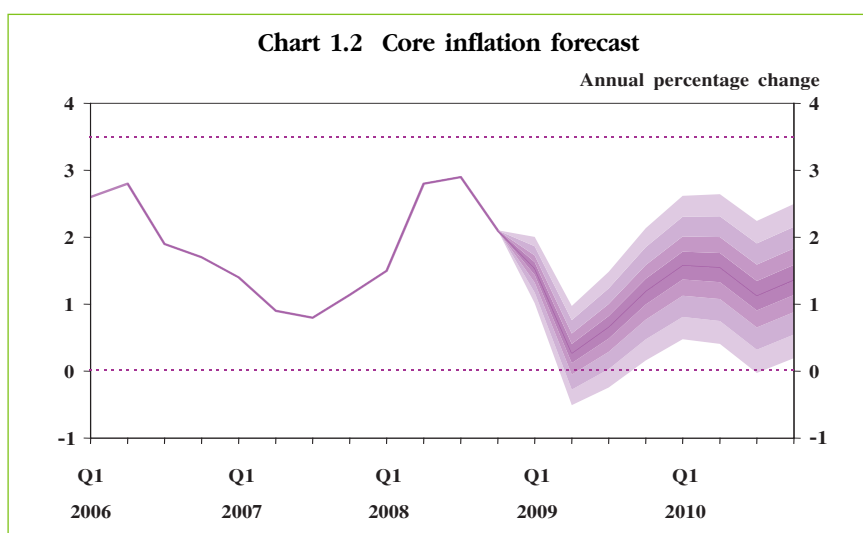
utility charges and fees for certain types of public transportation helped reduce the public’s concerns over the cost of living and helped to lower inflation expectations.

Going forward, the MPC assessed that price pressures were lower than anticipated in the previous *Report*, due to the softer trend of world oil prices than previously anticipated. Moreover, the lower-than-expected economic expansion made it more difficult to pass on costs to consumers. In addition, the government’s measures to alleviate the public’s cost of living were partially extended for 6 months. Together with lower inflation expectations, this should help reduce pressures for higher wage bargaining.

Headline inflation was likely to stay moderate, with likelihood of negative inflation during some periods of 2009, particularly during months when oil prices are much lower compared to those of the same period the previous year. Nevertheless, the MPC deemed that this trend did not signify deflation, as it did not reflect a broad-based decline in prices, but resulted directly from the swift reduction in oil prices. Moreover, headline inflation was not expected to remain negative for a prolonged period such that it would lead to a delay in private consumption. However, the MPC expected that both headline and core

inflation would slowly increase in tandem with the economic recovery and the cumulative easing of monetary policy.

Based on the above analysis, the MPC adjusted the inflation forecast downwards over the upcoming 8 quarters with headline inflation ranging between -1.5 - 0.5 per cent in 2009 and between 1.5 - 3.5 per cent in 2010, while the range for core inflation was expected at 0.5 - 1.5 per cent in 2009 and at 1 - 2 per cent in 2010. The fan chart for headline inflation is skewed upwards throughout the entire forecast period, reflecting upside risks from rising oil prices. The fan chart for core inflation, on the contrary, is skewed downwards throughout the forecast period to reflect increasing risks to growth.



Note: The fan chart covers 90 per cent of the probability distribution

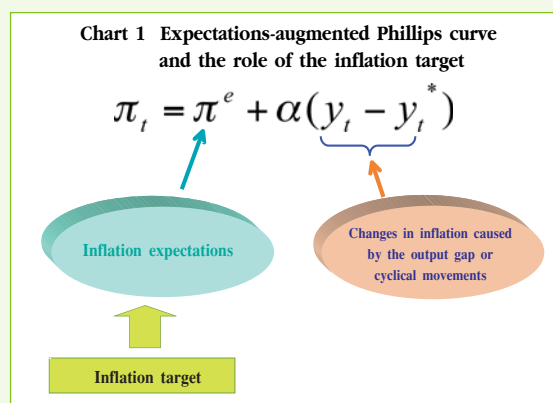
Taking into consideration the conditions and trends of inflation as well as those of economic expansion, the MPC viewed that the overall risks to growth of the Thai economy going forward increased drastically due to both external and domestic factors. On the other hand, risks to inflation decreased markedly and were expected to remain moderate throughout 2009, thereby permitting the easing of monetary policy to support economic recovery. The MPC therefore lowered the policy interest rate by 1.00 per cent per annum during the meeting on 3 December 2008, and lowered the policy rate further by 0.75 per cent per annum during the meeting on 14 January 2009, leaving the current policy rate at 2.00 per cent per annum.

## Setting an appropriate inflation target

One of the main objectives of monetary policy in countries around the world, regardless of regime, is to ensure price stability in the economy, which is defined as low and stable inflation. Price stability not only helps to protect the public's purchasing power or the future value of money from declining rapidly and continuously, but also helps to reduce uncertainty which could affect private consumption and investment decisions, in turn affecting the economy's potential output. Moreover, price stability helps to maintain price competitiveness of businesses in both domestic and international markets, making it a prominent factor supporting sustainable economic growth.

### 1. The importance of setting an inflation target

An explicit inflation target facilitates a central bank in achieving its price stability objective. Setting and announcing an inflation target which is clear and valid - that is, easy to communicate to the public, suitable to the economic structure, and achievable - together with a cautious approach to monetary policy decision-making by central bankers, would increase the credibility of monetary policy. In turn, the inflation target would help guide the public's inflation expectations. This can be explained by the expectations-augmented Phillips curve equation (Chart 1), where the inflation rate at time  $t$  ( $\pi_t$ ) is comprised of 2 parts: the first relating to inflation expectations ( $\pi^e$ ), and the latter relating to changes in demand pressure, which is determined by the economic cycle. Such demand pressure can be measured by the output gap, which is the difference between actual output ( $y_t$ ) and potential output ( $y_t^*$ ). Therefore, at any point in time, actual inflation could deviate from expected inflation via demand pressure, as determined by the economic cycle. However, such deviations should average near zero in the long run. As a result, the inflation rate in the long run will be determined by the public's inflation expectations. As a result, provided that the conduct of monetary policy under the inflation targeting regime is effective in guiding inflation expectations, the level of expected inflation and the actual level of inflation should remain within the announced inflation target range.



### 2. Important issues that need to be considered when setting an inflation target

In setting an inflation target which fulfills the primary objective of maintaining price stability, three important issues need to be considered, as follows.

2.1 Selecting the targeted price index: In theory, the targeted price index can be any price index that is representative of the public's cost of living. A possibility is the Consumer Price Index (CPI) or other price indices which are closely related to CPI, such as CPI excluding items with highly volatile prices; in the case of Thailand, this includes fresh food and energy. Such an index (which excludes items with volatile prices) would better reflect the true underlying trend of inflation as well as demand pressure, otherwise known as the second-round effect. These are important characteristics of a targeted price index, as monetary policy is usually aimed at taking care of demand pressures. In addition, the targeted price index should be easy to communicate and easily understood by the public. This should help enhance its effectiveness in guiding the public's inflation expectations.

2.2 Inflation target level: An issue that should be considered is the ability of people in various groups of the economy to adjust to changes in the price level, particularly retirees whose main income derives from interest income from savings, or fixed-income employees or labourers who have low bargaining power. Such groups can be particularly susceptible if the inflation target is set at a high level, as their income may not be able to catch up with inflation, subsequently eroding their purchasing power. Moreover, empirical studies in many countries indicate that high and volatile inflation significantly reduces people's purchasing power and economic growth in the long run. Additionally, it is generally accepted that there is a relationship between the level of inflation and its variance; that is, variance of inflation usually rises with the level of inflation. Hence, setting an inflation target at a high level will cause various prices in the economy to become more uncertain, in turn affecting private consumption and investment plans and decisions, and eventually affecting economic growth. Furthermore, the inflation target level should also be consistent with trading partners' inflation in order to maintain price competitiveness of Thai products.

2.3 Inflation target range and time horizon: The announcement of a point target for inflation with a short and clear time-period is the most obvious way to show the central bank's commitment to its inflation target. This is partly because a short time-period will enable central bankers, as well as the public, to quickly detect if inflation falls outside the target range. In practice however, there are some drawbacks to a point target. Because inflation can be influenced by many factors, including temporary supply-side factors such as unfavourable weather conditions, while there are time lags in monetary policy transmission, most central bankers choose to set their inflation target as a range or a point with a tolerance band. This is set in conjunction with the time horizon which is used to anchor inflation expectations, which can range widely, from a continuous horizon ("at all times") as in the UK, to a horizon "over the business cycle", as used in Australia. However, in the latter case, it is unclear as to how many years the business cycle may span.

### **3. Thailand's inflation target in the past up to 2008**

Since May 2000, Thailand's inflation target has been core inflation (the change in the CPI index that excludes raw food and energy prices), with a target range of between 0 - 3.5 per cent per annum, measured as a quarterly average. Because core inflation can reflect demand pressures well, and is less volatile than headline inflation, monetary policy would not have to fluctuate unnecessarily, as doing so could lead to excessive output volatility. Meanwhile the time horizon for the target range, measured as a quarterly average, allows any deviation of inflation from the target range to be promptly detected. In addition, the inflation target range of 0 - 3.5 per cent per annum is consistent with trading partners' inflation.

The MPC reassesses the appropriateness of the inflation target every year as part of its internal proceedings. The MPC agrees that the current inflation target is well-understood and is familiar to the public. This helps in maintaining price stability, and helps to support growth of the Thai economy. Furthermore, the consistency of the inflation target helps enhance the effectiveness in anchoring the public's inflation expectations.

### **4. Inflation target in 2009**

Under the new BOT Act, the MPC is required to set a target for monetary policy in conjunction with the Minister of Finance every year before submitting the target for Cabinet approval before year-end for implementation in the following year. At this juncture, the MPC and the Minister of Finance have carefully considered the appropriateness of the inflation target, taking into account issues mentioned above in Section 2. They mutually agreed to propose an inflation target for 2009 as the quarterly average of core inflation, in order to achieve continuity in the conduct of monetary policy. This would also show the MPC's commitment in containing inflation within the announced target. Nevertheless, in order to reduce the probability of deflation, the MPC adjusted the target range to 0.5 - 3.0 per cent per annum, which is in line with trading partner's inflation in order to maintain price competitiveness of Thai products.

Should realized inflation breach the announced target, the MPC will send an open letter to the Cabinet explaining why the target has been breached, specifying the direction of monetary policy going forward as well as the time which is expected to be required to bring inflation back to within the target range. This is an international practice used to ensure that the MPC remains committed to its mandate of maintaining price stability, particularly in periods when the inflation target is temporarily breached due to unexpected events outside the control of monetary policy.

The inflation target for 2009 mentioned above is currently awaiting approval by the Cabinet.