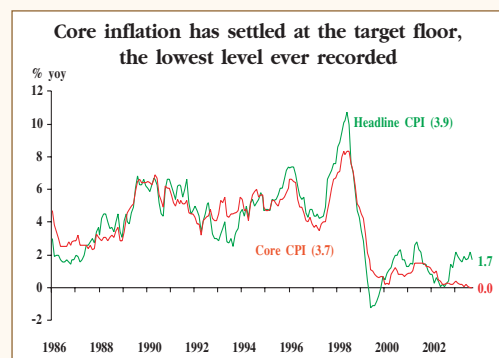


Analysis on the low inflation trend and assessment of deflationary risks

Core inflation has remained low for more than one year and there is a possibility that core inflation may fall outside the target range of 0 - 3.5 per cent per annum if adversely effected by external factors. In September, core inflation, for the second consecutive month, stood at 0.0 per cent compared to the same period last year. As a result, core inflation in 2003 Q3 averaged 0.0 per cent. Low core inflation, however, did not imply deflation^{1/} as headline inflation grew year-on-year by 1.7 per cent and the economy has been growing strongly. Nevertheless, since core inflation is Bank of Thailand's policy target for monetary policy, the MPC deemed it important to closely monitor and analyse the current situation so as to foster the correct understanding of the public.

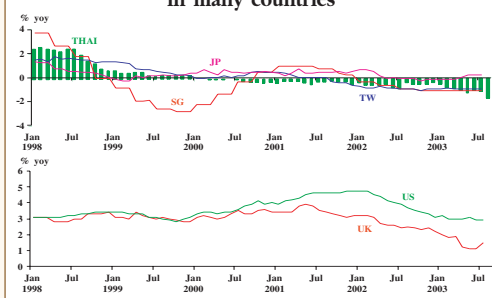
1. The difference between headline inflation and core inflation

During the past 9 months, headline inflation averaged 1.8 per cent compared to the same period last year, while core inflation averaged 0.2 per cent. The main reason for the divergence between these 2 inflation measures was the price level of raw food which rose 7.4 per cent, especially rice and cereal products, as well as vegetable and fruit prices. Furthermore, oil prices rose in line with the increase

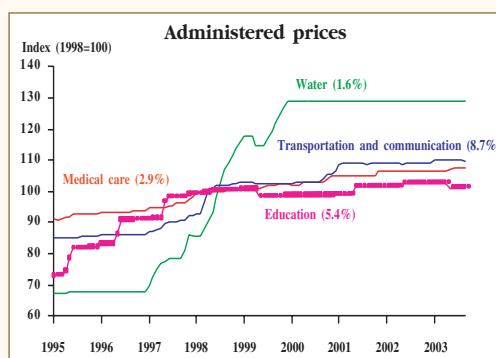


Source: Trade and Economic Index Bureau, Ministry of Commerce

The downward trend of housing rent is common in many countries



Source: CEIC



Source: Trade and Economic Index Bureau, Ministry of Commerce

in world oil prices, which resulted in energy prices rising by 6.6 per cent. Nevertheless, taking a longer time frame since 1986, the average headline and core inflation had been close to one another at 3.9 and 3.7 per cent, respectively.

2. Reasons for low core inflation despite continuous high economic growth

- **Continuous decline in housing rent** (accounts for 24 per cent of the consumer price index basket). In September, rent declined by 1.6 per cent compared to the same period last year, due mainly to the low interest rate. As a result, consumers shifted their demand from rental accommodation to home ownership, causing rents to decline. Similarly, housing rents in other countries (Asian region, US, UK and Japan) also declined continuously.

- **Administered price measures** on basic utilities, transportation and communication, medical care,

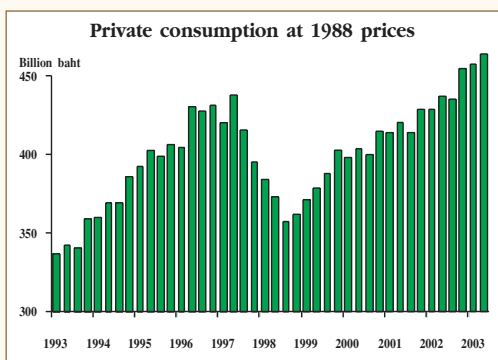
^{1/} A situation where the price level falls continuously, which generally means continuous negative headline inflation.

and education. As a result, commodities in this group (which accounts for 22 per cent of the consumer price index basket) seldom increased or increased by only slightly. However, in the long run, the price level in this group is expected to rise, reflecting higher production costs.

- **Intense competition** caused producers to maintain prices in order to retain their market shares. This could be observed from the BSI Survey where most businesses' first concern, since December 2002, where intense competition from the domestic market.

3. Outlook and adjustment of core inflation

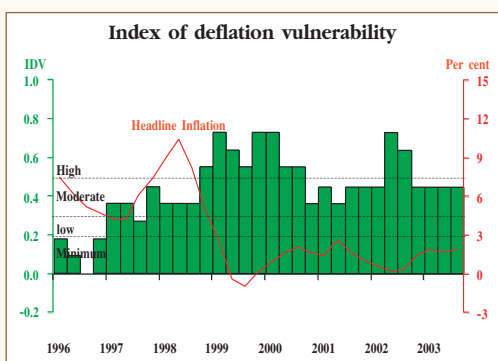
Regarding the outlook of core inflation, it is clear that there is minimal demand-side pressure on core inflation. Furthermore, supply-side factors, for example capacity utilization and employment rate, remain low. However, due to the increase in private consumption, which is close to the pre-crisis level, and continuous economic growth, core inflation should rise in the near future.



Source: National Economic and Social Development Board

in productivity and inflation expectations.

4. Risk of deflation



Source: Bank of Thailand

Moreover, despite the omission of raw food and energy from core inflation, changes from these 2 groups will still pass through to commodities in the food and beverages, and transportation and communication group in the core consumer price index basket, which in turn will adjust core inflation in the following periods.

Thus, in the long run, core and headline inflation should converge towards each other. Nevertheless, headline and core inflation are expected to remain low, in line with trading partners' inflation rate due to globalisation, intense competition, increase

In assessing risks of deflation in the following periods^{2/}, it was found that the Index of Deflation Vulnerability (IDV) for 2003 Q3 would be at 0.45, that is, moderate risk of deflation, the same as in 2003 Q2. This was a result of the low core inflation, large output gap as well as low money supply and credit growth rate. The aforementioned risk, however, is expected to lessen following continuous economic and credit expansion in the following periods

^{2/} More details on this subject can be found in the July *Inflation Report* in the Box entitled "Assessment of Deflation Risk in Thailand"