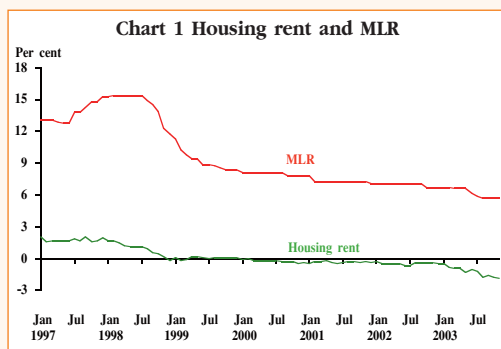


Relationship between Housing Rent and Interest Rates

In the past one and a half years, core inflation has remained steadily low, pulled down mainly by the falling housing rent. Since housing rent constitutes approximately 24 per cent of the basket used to calculate core consumer price index, the question which arises is whether core inflation including housing rent is an appropriate target for the MPC to use in monetary policy considerations. Concerns are also raised whether core inflation is a good indicator of macroeconomic conditions. The recent strong output acceleration did not show signs via price pressures as measured by core inflation, as housing rent still declined year-on-year.

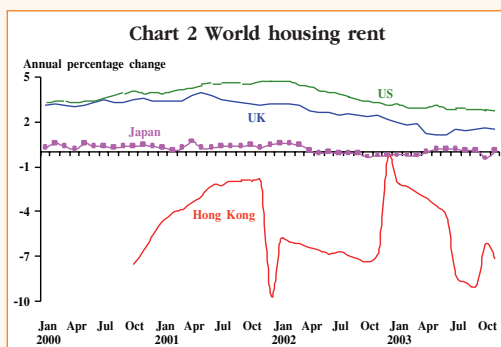


Source: Bank of Thailand

In addition, the continuous decline of housing rent since the economic crisis seemed to move in the same direction with those of interest rates. If this correlation persists permanently and monetary policy is pursued to preempt overheating, the effect of monetary policy on core inflation might be in the wrong direction. In other words, core inflation may rise when monetary policy tightens.

Excess supply in the real estate market and housing rent adjustments

One reason that housing rent has been declining continuously since the crisis is excess supply in the real estate market which put downward pressure on housing prices. As housing rent is usually based on housing prices, declining housing prices lead to declining housing rent. Excess supply of housings continuously emerges in the market as non-performing assets of financial institutions are sorted and then auctioned off. The continuous accommodating monetary policy stance which leads to declining lending rates, prompted a number of renters to buy their own housings, depressing housing rent further as analyzed in the July 2003 issue of the *Report*. These housing rent adjustments are not, however, unique to Thailand. In the US, approximately 10 per cent of houses for rent



Source: CEIC

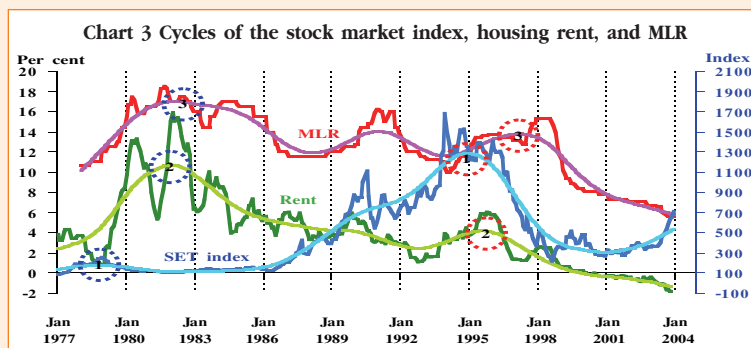
remain vacant, pushing housing rents downwards. Other countries with excess supply in the real estate sector, such as Hong Kong, also experience continuous decline in housing rents.

Downward pressures on housing rent will remain as long as excess supply exists in the housing sector. Once the real estate sector returns to equilibrium, housing rents shall again be an indicator of overheating in the economy.

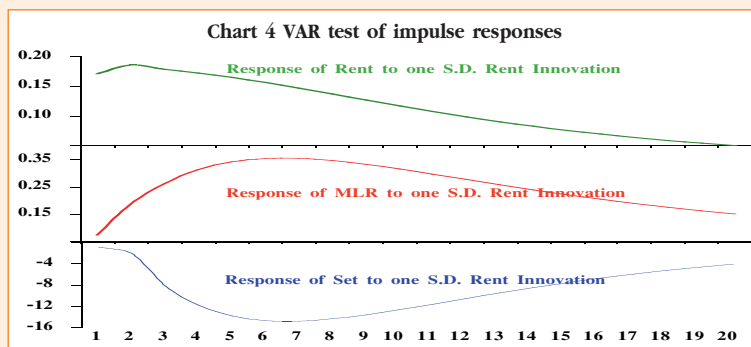
Housing rent and interest rate cycles

In assessing the appropriateness of including housing rent in the core consumer price index basket, the MPC investigates the positive relationship between interest rates and housing rent. Housing rent is hypothesized to be the normal returns on real estate. Any acceleration of activities in the real estate sector will be ultimately reflected on housing price and rent. If this is the case, monetary policy should respond in the same direction to the changes in housing rent. In other words, if housing rent rises in line with economic activities, monetary policy should be tightened ultimately.

Analyzing cycles of the housing rent^{1/}, the Minimum Lending Rate (MLR), and the stock market over the past 25 years (Graph 3), two peaks are found. Rising wealth in the stock market leads to an acceleration in the real estate sector and subsequently to that of the real estate returns or housing rent. Results from the Vector Autoregression (VAR)^{2/} confirm the response of MLR to a change in housing rent that subsequently leads to a downward adjustment in the stock market index. In the conduct of monetary policy, housing rent is thus useful as a demand-side pressure indicator.



Source: Stock Exchange of Thailand, Bank of Thailand and Ministry of Commerce



Source: Bank of Thailand estimates

The exclusion of housing rent from the core inflation calculation would entail an accuracy loss in measuring the cost of living. Core consumer price index excluding rent accounts for only around 57 per cent of the headline consumer price index.

^{1/} The data used in this analysis are those of housings which consists of housing rent and other housing expenditures. Housings constitute around 29 per cent of the basket used to calculate core inflation.

^{2/} Testing the relationships and interactions among 3 variables, namely MLR, the stock market index, and housing rent by introducing an innovation of 1 standard deviation to housing rent, and assess the responses. Data used are monthly data from January 1977 to December 2003.