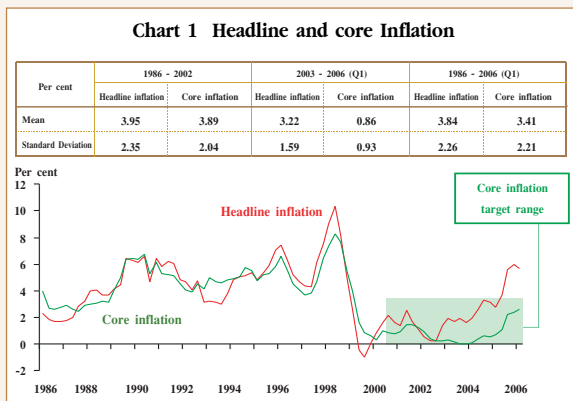
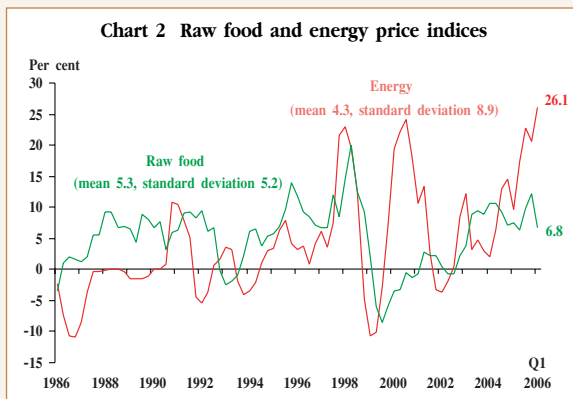


The relationship between headline and core inflation

The use of core inflation as a target for monetary policy is aimed at achieving price stability in the long-term so that monetary policy does not have to respond to external supply pressure from oil and farm prices. Nevertheless, core inflation still represents headline inflation and, despite the exclusion of raw food and energy components, still constitutes more than 75 per cent of the consumer price index (CPI) basket. Historical comparison shows that although core inflation is less volatile than headline inflation in the short-term, the 2 inflation measures are closely related in the long-term, as can be seen during 1986 - 2002 when core inflation and headline inflation averaged closely at 3.89 and 3.95 per cent, respectively. This close relationship between headline and core inflation in the long-term means that overall price stability can be achieved through the stability of its core component.



Source: Trade and Economic Index Bureau, Ministry of Commerce and calculations by the Bank of Thailand



Source: Trade and Economic Index Bureau, Ministry of Commerce

In general, the effect of an increase in world oil prices on headline inflation would be immediate, while the effect on core inflation would be slower.¹ This generally causes a divergence between headline and core inflation of approximately 4-6 quarters, after which the 2 measures would converge. However, since 2002 Q4, the divergence between headline and core inflation has been significant, exceeding 2 per cent and having yet to converge (Chart 1). Thus, the difference between the mean values of headline and core inflation from 1986 to the present is larger, raising the question as to whether core inflation is still a suitable target for price stability.

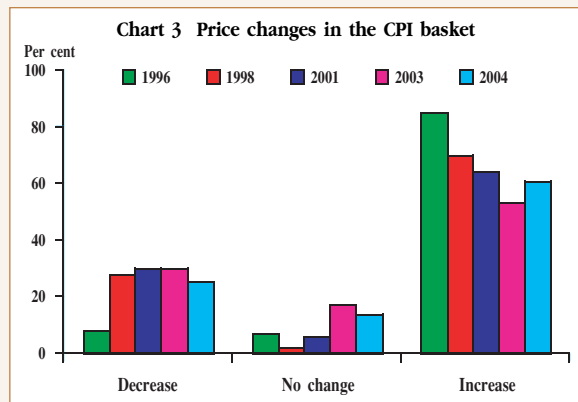
Structure and transmission mechanism of Thai prices

Since 1997, prices of raw food and energy components of the CPI basket have become more volatile than previously observed (Chart 2). Latest data suggest that increases in energy prices have been quite persistent, following the increase in world oil prices. This coupled with the increase in farm prices has caused headline inflation to rise markedly. Nevertheless, core inflation has remained rather inert as a result of the slow pass-through of higher costs to domestic prices of goods and services, and consequently the divergence between headline and core inflation has become longer. The slow transmission mechanism of Thai prices can be explained by:

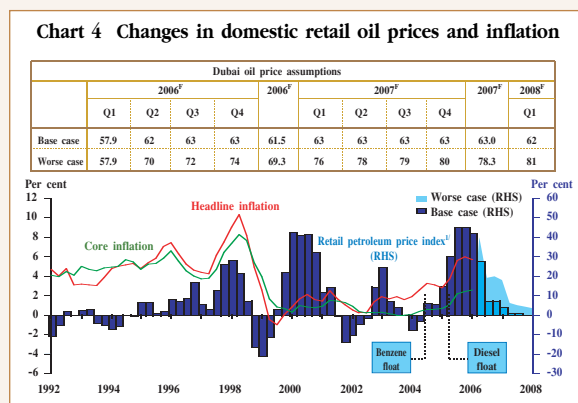
(1) Price administration measures imposed by various authorities with the aim to prevent unjust price increases by businesses as well as to limit the impact of price changes on consumers. The continuous increase in world oil prices has prompted the authorities to become more rigorous in their price administration efforts, as can be seen from an increase in the proportion of price administered goods and services in the CPI basket from approximately 33 per cent in 2003 to 40 per cent

¹ Our analysis by means of the Vector Autoregression (VAR) to measure the impact of an oil price shock on inflation, using data from 1994 to 2005, shows that a Dubai crude oil price shock would result in an immediate impact on headline inflation with a slower response of core inflation, in line with the divergence between headline and core inflation observed.

in 2005. Hence, businesses have not been able to fully pass on the increase in costs to consumers. As a result, the indirect effect of higher oil prices on core inflation has been limited, compared with headline inflation, which is directly affected by rising oil prices.



Source: Calculations by the Bank of Thailand



Remark: F = Forecasting

^{1/} Percentage change from the previous year

Source: Trade and Economic Index Bureau, Ministry of Commerce and Dubai oil price assumptions by the Bank of Thailand

The retail oil price subsidy coupled with other price administration measures led to pent-up or delayed pressure and thus caused the transmission mechanism to become distorted. However, the end of retail oil price subsidy and the fact that the authorities have begun to allow some administered prices to adjust mean that going forward, given that world oil prices do not accelerate like in the previous 2 years or rise significantly above the base case assumptions used in our inflation forecasts, the MPC views that headline inflation should trend down and converge with core inflation in early 2007. Should the worse case assumption hold instead, where the Dubai crude oil price could reach 80 US dollars per barrel, headline inflation would trend down slower than in the base case and would converge with core inflation 2-3 quarters later. On the contrary, a deceleration in domestic demand would alleviate pressure on costs and in turn, help lower pressure on inflation, resulting in a faster-than-expected convergence. Therefore, in the absence of further distortions to the transmission mechanism, the 2 inflation measures should move together in the long-term, making core inflation still a suitable target for monetary policy in the pursuit of price stability.

(2) Intensified competition, which has pressured businesses to absorb higher costs in order to preserve market share. An analysis of individual items in the CPI basket shows that the proportion of goods and services with upward price adjustments began to decline in 1996, while the proportions of goods and services with downward price adjustments or unchanged prices increased. Although latest data show that the proportion of goods and services with upward price adjustments has recently edged up, it remains well below the historical average (Chart 3). This is most likely a result of a marked increase in costs, which forces businesses to adjust their prices to some extent.

Impact of higher retail oil prices on Thai inflation

World oil prices, which began to increase significantly in late 2002, coupled with strong economic growth in 2003 caused headline inflation to rise continuously. As a result, the authorities started to subsidize the retail prices of oil through the Oil Fund in January 2004 to mitigate the impact on the economy. However, as world oil prices continued to climb, the burden of subsidy grew significantly, prompting the authorities to lift the price cap on benzene oil in October 2004 and diesel oil in June 2005. Nevertheless, pressure from higher retail oil prices had already begun to translate into higher headline inflation since 2004, evident from a marked acceleration of headline inflation from core inflation (Chart 4). The phenomenon became even more pronounced after the end of the subsidy.