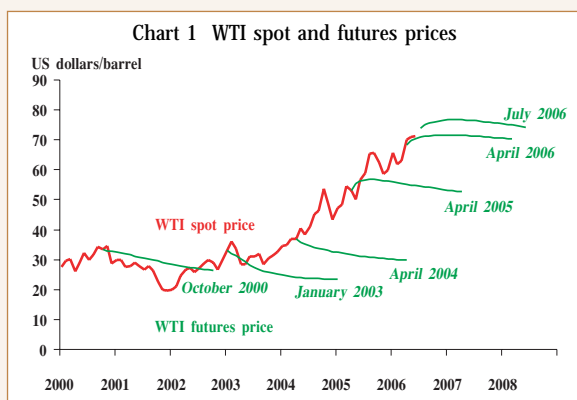


The role of monetary policy and supply shocks

It is widely understood that the role of monetary policy is to oversee inflation in the long term in order to maintain price stability and thereby facilitate the economy to grow along a sustainable path. Thus, monetary policy does not have to respond to supply-side pressures, for example oil and farm prices that are highly volatile in the short run. Instead, it should focus on demand-side pressures as well as the second-round effect of inflation that could lead to a wage-price spiral where workers demand a pay rise higher or equal to expected inflation in order to maintain their real income. Thus, the effort to maintain inflation at a low level will help anchor inflation expectations at an appropriate and controllable level, which will then lead to economic stability overall. Nevertheless, world oil prices that have been rising since 2000 and are likely to remain high going forward, which many view as a supply shock, are exerting pressure on both inflation and growth. This, of course, raises the question as to how monetary policy should respond in such circumstances.

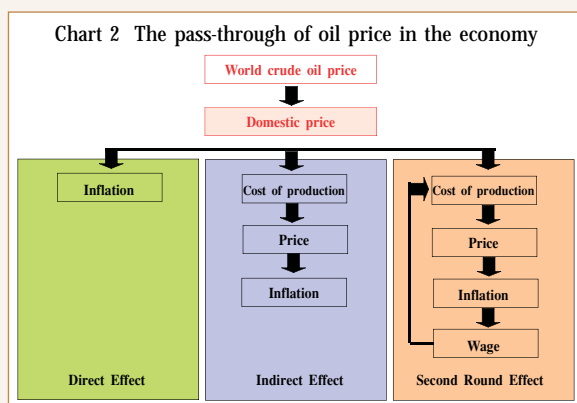
The impact of oil price and its pass-through in the economy



Remark: WTI futures price is calculated using the average price of the first 2 weeks of the month of the *Inflation Report's* release. Delivery period is within 2 years.

Source: Bloomberg

The current surge in inflation is largely induced by oil prices, but it differs from the first and second oil shocks during 1973-1974 and 1979-1981. Then, cost-pushed inflation was a result of a production cut by the OPEC countries in order to push prices up. Such an increase in prices created an incentive for other oil producing countries to increase production capacity, which subsequently led to an increase in supply that ultimately pulled oil prices down. Thus, only a temporary rise in inflation was experienced. However, factors that cause the current acceleration in oil prices come not only from the supply side but also from the demand side. The demand-pulled inflation is a result of an increase in the demand for oil from both industrial as well as developing countries, in particular China. Such an increase in the demand for oil is likely to cause prices to remain high going forward as reflected by the latest West-Texas Intermediate (WTI) crude oil futures prices, which show a stabilising trend rather than a downward trend as previously observed (Chart 1).



Source: Bank of Thailand

is an increase in the costs of living but because demand remains buoyant, there is room for workers to bargain for a wage increase (Chart 2). While the effects of the first 2 channels are likely to be short to medium term, the second-round effect is likely to be more prolonged and may result in a wage-price spiral, causing inflation to accelerate. In other words, higher costs

of living during a period of high growth can create pressure for wages to rise, which in turn will translate into higher production costs and force producers to pass these costs onto consumers again. The continuation of this loop will cause inflation to remain high for an extended period of time.

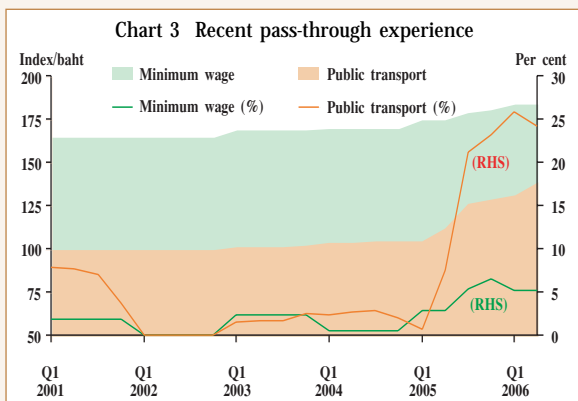
The role of monetary policy in maintaining long-term stability

Table 1 International monetary policy during the past 3 months

	Current Policy Rate (%)	Last meeting / % Change	Δ Jan-Dec 05 (%)	Δ Jan 06- Present (%)	Inflation (%)
Japan	0.25	14 Jul/+0.25	-	0.25	0.6 May
Hong Kong	6.75	30 Jun/+0.25	2.00	1.00	2.1 May
Taiwan	2.50	29 Jun/+0.125	0.50	0.10	1.6 May
USA	5.25	29 Jun/+0.25	2.00	1.00	4.2 May
Sweden	2.25	21 Jun/+0.25	0.50	0.75	1.6 May
India	5.75	9 Jun/+0.25	0.50	0.25	5.3 Apr
South Korea	4.25	8 Jun/+0.25	0.50	0.50	2.6 Jun
Australia	5.75	3 May/+0.25	0.25	0.25	3.0 2006 Q1
China*	5.85	27 Apr/+0.27	0	0.27	1.5 Jun
Canada	4.25	11 Jul/No change	0.75	1.00	2.8 May
Euro area	2.75	8 Jul/No change	0.25	0.50	2.5 May
Philippines	7.50	29 Jun/No change	0.75	-	6.7 Jun
UK	4.50	21 Jun/No change	-0.25	-	2.2 May
New Zealand	7.25	8 Jun/No change	0.75	-	4.0 2006 Q2
Norway	2.75	31 May/No change	0.50	0.50	2.3 May
Malaysia	3.49	22 May/No change	0.30	0.50	3.9 May
Indonesia	12.25	6 Jul/-0.25	5.32	-0.50	15.5 Jun

Remark: *China increased its reserve requirement from 7.5 per cent to 8.0 per cent on 16 June 2006

Source: Reuters



Source: Ministry of Commerce and Ministry of Labour

For the Thai economy, the impact of higher oil prices has not yet been fully felt because many goods and services are still subjected to some kind of price administration measures, including retail oil prices until recently. Nevertheless, the indirect and second-round effects of oil prices have become more apparent as reflected, for example, by a continuous rise in prices of many public transportation services since the latter half of 2005 as well as the increases in minimum wages (Chart 3). Thus, in the absence of a more evident adjustment in consumers' spending habit, the persistence of high oil prices will continuously exert pressure on inflation and may eventually lead to a stronger pass-through, especially when prices of administered goods and services are gradually allowed to adjust. This will increase the risk of a wage-price spiral, which can damage stability in the long run.

Given the above, the MPC has shown its firm commitment to achieve the monetary policy objective by continuously raising the policy interest rate with the aim to anchor inflation expectations as well as induce consumers to cut back on unnecessary spending and borrowing. At the same time, higher rates of return will act as an incentive for more savings, which will help alleviate demand-side pressure and control the second-round effect of inflation, which will ultimately lead to price stability in support of economic growth in the long run.

In an environment where oil prices are likely to remain high, all parties need to make some adjustments in order to minimise the overall impact. For example, producers need to find more effective ways in managing their resources while consumers need to cut down on their spending because a continuous acceleration in demand during times of high prices will allow producers to pass costs onto consumers more easily, resulting in a faster and stronger pass-through of inflation that may ultimately undermine economic stability. For instance, during the first oil shock, the US used an accommodative monetary policy stance to stimulate growth in the short term. As a result, prices rose continuously and remained high for a long period of time before finally coming down.

The experiences of many countries suggest that the way to prevent a continuous rise in inflation due to rising oil or commodity prices is to anchor the public's inflation expectations at a low level. That can be achieved only if policy makers are committed to maintaining price stability via a consistent pattern of policy responses. This is so because once inflation expectations are low, the degree of the second-round effect of inflation will also be low as there is less need for prices and wages to increase. Thus, since the beginning of the current oil price hike, many countries have resorted to monetary tightening and during the last 3 months, interest rates in most countries have been on an upward cycle given that price pressure has not yet dissipated (Table 1).