The study of cost pass-through to prices amidst rising oil and commodity prices

Economic theory suggests that inflation expectations can affect inflation through 2 main channels - through wage bargaining by employees and price setting by businesses. For instance, if employees expect inflation to remain high going forward, they are likely to demand higher wages in order to maintain their purchasing power. This, in turn, would put pressure on production costs and cause wholesale and retail prices to rise further.

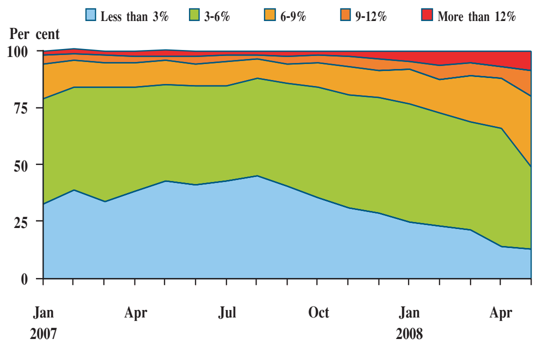
Monitoring the trend of inflation expectations is therefore crucial for the conduct of monetary policy. Currently, Thailand's financial markets lack inflation-linked bonds, whereby the spread between the yields of inflation-linked bonds and conventional nominal bonds with comparable maturities and ratings would reflect investors' inflation expectations. As a result, inflation expectations are monitored through other channels, such as through consumer and business surveys which reflect inflation expectations in the short-term and from the implied forward curve where inflation expectations in the long-term can be measured.

From the most recent Business Sentiment Survey conducted in May 2008, it was revealed that **cost and inflation expectations over the next 12 months increased continuously.** In fact, around 50 per cent of businesses expected their costs to rise by more than 6 per cent, while 40 per cent expected inflation to be higher than 6 per cent over the next 12 months. Furthermore, the proportion of businesses who expected inflation to remain high continued to increase from mid-2007. A sharp increase was observed since April 2008, in line with the acceleration in agricultural prices, and particularly in rice prices, coupled with continued pressure from oil prices (Charts 1 and 2).

In addition, the BOT launched a special survey[1/] enquiring about businesses expectations concerning production costs and cost pass-through to prices, in order to better understand their views about inflationary expectations, and particularly the effect of cost push pressures. The 4 main findings are summarised below:

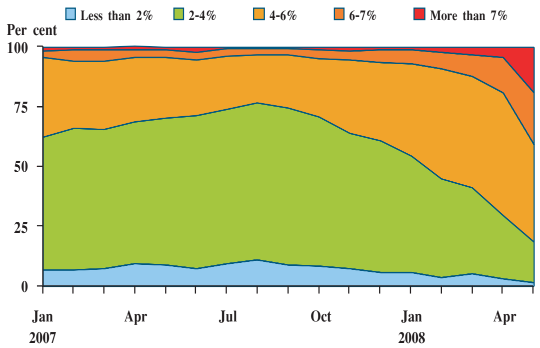
1) **More than 90 per cent of businesses were affected by rising costs over the past 12 months.** Of those, about 60 per cent faced substantially higher costs. At the same time, more than 40 per cent were expected to encounter substantially higher costs over the next 12 months (Chart 3).

Chart 1 Cost expectation over the next 12 months



Source: The Business Sentiment Survey, May 2008

Chart 2 Inflation expectation over the next 12 months



Source: The Business Sentiment Survey, May 2008

[1/] From the business sentiment survey conducted by the BOT in May 2008, the survey was sent to 865 businesses covering all business areas for information regarding their expectations on production costs and cost pass-through to prices. 341 businesses or 39.4 per cent of total recipients responded. In this survey, variable costs include raw materials/finished goods, energy, wages, logistics, financial costs, etc.

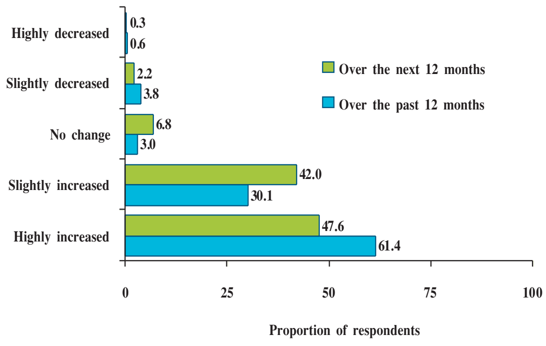
2) The top 3 sources of pressure which pushed up variable costs were derived from production costs (both of raw materials and finished goods), energy costs, and labour costs. Meanwhile, **pressure from financial costs was minimal** (Chart 4).

3) Businesses were able to partially pass-through the rise in variable costs to prices, with most businesses raising prices by less than 50 per cent of the increase in their variable costs. Meanwhile, bid contracts, pre-committed contracts, proposals for price adjustments pending approval from the Department of Internal Trade, and intense competition were the main reasons why businesses did not or could not adjust prices (Charts 5.1 and 5.2).

4) Cost pressure on prices over the next 12 months is expected to remain. **Businesses are expected to gradually increase their prices over the next 12 months to compensate for rising costs during past periods** (Charts 5.3 and 5.4).

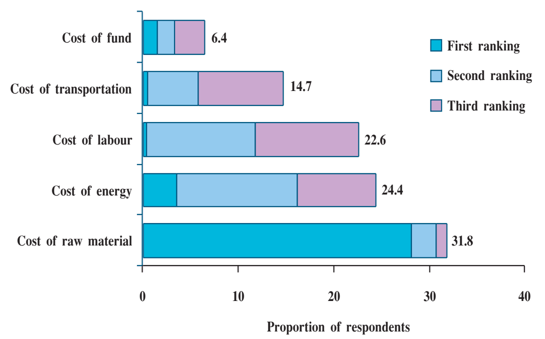
In summary, cost pass-through to prices is a gradual process, where in the short-term businesses are willing to bear a higher proportion of the burden arising from higher costs. This gradual process of cost pass-through coupled with business expectations of upward cost pressures over the next 12 months would put pressure on inflation expectations going forward.

Chart 3 The change in variable costs



Source: The Business Sentiment Survey, May 2008

Chart 4 Pressure from variable costs



Source: The Business Sentiment Survey, May 2008

Chart 5.1 Wholesale price adjustment

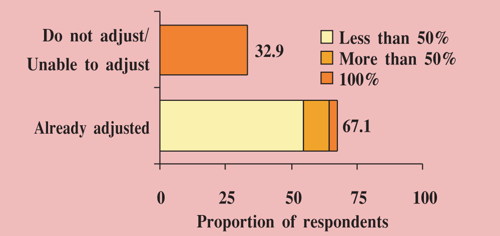


Chart 5.2 Retail price adjustment

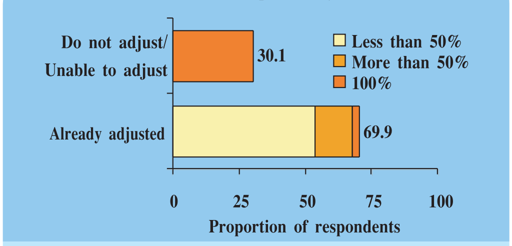


Chart 5.3 Wholesale price adjustment over the next period

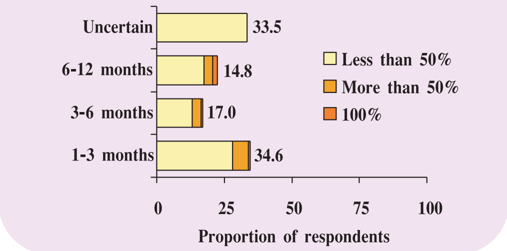
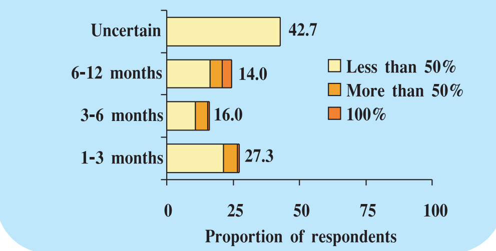


Chart 5.4 Retail price adjustment over the next period



Source: The Business Sentiment Survey, May 2008