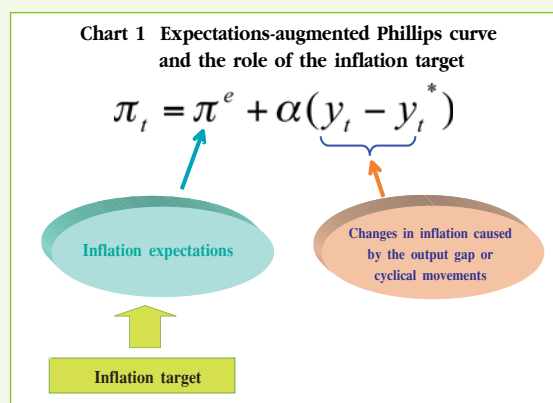


## Setting an appropriate inflation target

One of the main objectives of monetary policy in countries around the world, regardless of regime, is to ensure price stability in the economy, which is defined as low and stable inflation. Price stability not only helps to protect the public's purchasing power or the future value of money from declining rapidly and continuously, but also helps to reduce uncertainty which could affect private consumption and investment decisions, in turn affecting the economy's potential output. Moreover, price stability helps to maintain price competitiveness of businesses in both domestic and international markets, making it a prominent factor supporting sustainable economic growth.

### 1. The importance of setting an inflation target

An explicit inflation target facilitates a central bank in achieving its price stability objective. Setting and announcing an inflation target which is clear and valid - that is, easy to communicate to the public, suitable to the economic structure, and achievable - together with a cautious approach to monetary policy decision-making by central bankers, would increase the credibility of monetary policy. In turn, the inflation target would help guide the public's inflation expectations. This can be explained by the expectations-augmented Phillips curve equation (Chart 1), where the inflation rate at time  $t$  ( $\pi_t$ ) is comprised of 2 parts: the first relating to inflation expectations ( $\pi^e$ ), and the latter relating to changes in demand pressure, which is determined by the economic cycle. Such demand pressure can be measured by the output gap, which is the difference between actual output ( $y_t$ ) and potential output ( $y_t^*$ ). Therefore, at any point in time, actual inflation could deviate from expected inflation via demand pressure, as determined by the economic cycle. However, such deviations should average near zero in the long run. As a result, the inflation rate in the long run will be determined by the public's inflation expectations. As a result, provided that the conduct of monetary policy under the inflation targeting regime is effective in guiding inflation expectations, the level of expected inflation and the actual level of inflation should remain within the announced inflation target range.



### 2. Important issues that need to be considered when setting an inflation target

In setting an inflation target which fulfills the primary objective of maintaining price stability, three important issues need to be considered, as follows.

2.1 Selecting the targeted price index: In theory, the targeted price index can be any price index that is representative of the public's cost of living. A possibility is the Consumer Price Index (CPI) or other price indices which are closely related to CPI, such as CPI excluding items with highly volatile prices; in the case of Thailand, this includes fresh food and energy. Such an index (which excludes items with volatile prices) would better reflect the true underlying trend of inflation as well as demand pressure, otherwise known as the second-round effect. These are important characteristics of a targeted price index, as monetary policy is usually aimed at taking care of demand pressures. In addition, the targeted price index should be easy to communicate and easily understood by the public. This should help enhance its effectiveness in guiding the public's inflation expectations.

2.2 Inflation target level: An issue that should be considered is the ability of people in various groups of the economy to adjust to changes in the price level, particularly retirees whose main income derives from interest income from savings, or fixed-income employees or labourers who have low bargaining power. Such groups can be particularly susceptible if the inflation target is set at a high level, as their income may not be able to catch up with inflation, subsequently eroding their purchasing power. Moreover, empirical studies in many countries indicate that high and volatile inflation significantly reduces people's purchasing power and economic growth in the long run. Additionally, it is generally accepted that there is a relationship between the level of inflation and its variance; that is, variance of inflation usually rises with the level of inflation. Hence, setting an inflation target at a high level will cause various prices in the economy to become more uncertain, in turn affecting private consumption and investment plans and decisions, and eventually affecting economic growth. Furthermore, the inflation target level should also be consistent with trading partners' inflation in order to maintain price competitiveness of Thai products.

2.3 Inflation target range and time horizon: The announcement of a point target for inflation with a short and clear time-period is the most obvious way to show the central bank's commitment to its inflation target. This is partly because a short time-period will enable central bankers, as well as the public, to quickly detect if inflation falls outside the target range. In practice however, there are some drawbacks to a point target. Because inflation can be influenced by many factors, including temporary supply-side factors such as unfavourable weather conditions, while there are time lags in monetary policy transmission, most central bankers choose to set their inflation target as a range or a point with a tolerance band. This is set in conjunction with the time horizon which is used to anchor inflation expectations, which can range widely, from a continuous horizon ("at all times") as in the UK, to a horizon "over the business cycle", as used in Australia. However, in the latter case, it is unclear as to how many years the business cycle may span.

### **3. Thailand's inflation target in the past up to 2008**

Since May 2000, Thailand's inflation target has been core inflation (the change in the CPI index that excludes raw food and energy prices), with a target range of between 0 - 3.5 per cent per annum, measured as a quarterly average. Because core inflation can reflect demand pressures well, and is less volatile than headline inflation, monetary policy would not have to fluctuate unnecessarily, as doing so could lead to excessive output volatility. Meanwhile the time horizon for the target range, measured as a quarterly average, allows any deviation of inflation from the target range to be promptly detected. In addition, the inflation target range of 0 - 3.5 per cent per annum is consistent with trading partners' inflation.

The MPC reassesses the appropriateness of the inflation target every year as part of its internal proceedings. The MPC agrees that the current inflation target is well-understood and is familiar to the public. This helps in maintaining price stability, and helps to support growth of the Thai economy. Furthermore, the consistency of the inflation target helps enhance the effectiveness in anchoring the public's inflation expectations.

### **4. Inflation target in 2009**

Under the new BOT Act, the MPC is required to set a target for monetary policy in conjunction with the Minister of Finance every year before submitting the target for Cabinet approval before year-end for implementation in the following year. At this juncture, the MPC and the Minister of Finance have carefully considered the appropriateness of the inflation target, taking into account issues mentioned above in Section 2. They mutually agreed to propose an inflation target for 2009 as the quarterly average of core inflation, in order to achieve continuity in the conduct of monetary policy. This would also show the MPC's commitment in containing inflation within the announced target. Nevertheless, in order to reduce the probability of deflation, the MPC adjusted the target range to 0.5 - 3.0 per cent per annum, which is in line with trading partner's inflation in order to maintain price competitiveness of Thai products.

Should realized inflation breach the announced target, the MPC will send an open letter to the Cabinet explaining why the target has been breached, specifying the direction of monetary policy going forward as well as the time which is expected to be required to bring inflation back to within the target range. This is an international practice used to ensure that the MPC remains committed to its mandate of maintaining price stability, particularly in periods when the inflation target is temporarily breached due to unexpected events outside the control of monetary policy.

The inflation target for 2009 mentioned above is currently awaiting approval by the Cabinet.