

Why did core inflation breach the target range in 2009 Q2?

The average core inflation of -0.1 per cent in 2009 Q2 (Table 1) might have caused some concerns that the Thai economy was experiencing deflation. Moreover, this was the first time since the adoption of inflation targeting in May 2000 that quarterly average core inflation fell below the MPC's target range of 0-3.5 per cent per annum. Nevertheless, this price contraction was expected by the MPC, and the previous *Inflation Report* had noted that there was a high probability that core inflation could temporary be close to zero or even negative.

Table 1 Core inflation

Annual percentage change	2009							
	Jan	Feb	Mar	Apr	May	Jun	Q 1	Q 2
Core inflation	1.6	1.8	1.5	1.0	-0.3	-1.0	1.7	-0.1

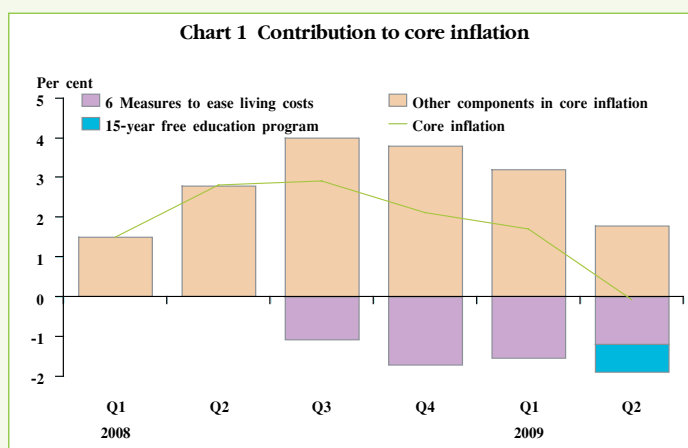
Source: Trade and Economic Index Bureau, Ministry of Commerce

The MPC assessed that the fall in prices did not signify deflation in Thailand^{1/} because it was mainly due to (1) government measures that helped lower the costs of living by subsidizing prices of specific goods and services and (2) the high-base effect in the previous year. In other words, negative inflation was not due to a decline in demand of such magnitude that firms had to cut down the prices of goods and services in order to prop up their sales. Neither was the price contraction caused by the public's expectation that prices would continue to fall, which would lead to postponement of consumption and investment decisions, and ultimately destabilizing the economy.

1. Reasons why core inflation fell below the target range

- **The government's 15-year free education program**, effective since May 2009, which subsidized education-related expenses, namely, tuition fees, school uniforms, school books and stationery, pushed core inflation down by 0.8 per cent. (Chart 1).

- **The government's "6 measures in 6 months" to ease living costs** (at present, only 5 measures remained), effective since August 2008, and had been extended twice to end in December 2009 artificially lowered core inflation by 1.2 per cent.



Source: Trade and Economic Index Bureau, Ministry of Commerce. Calculations by Bank of Thailand

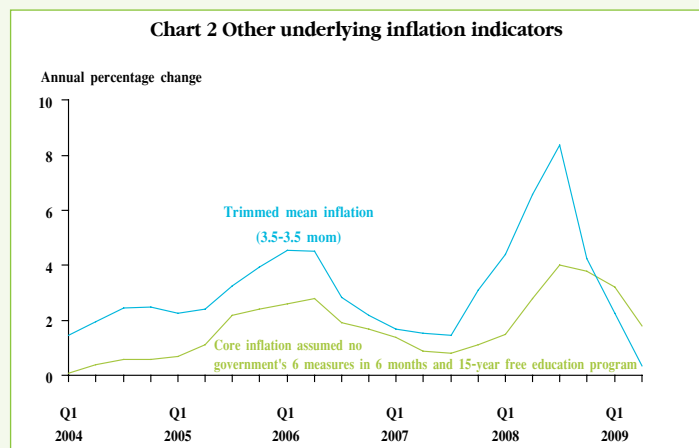
^{1/} For further details, see "Deflation." Box article in the January 2009 *Inflation Report*.

Related items that had bearing on core inflation included some subsidy on water charges, free third class train fares and subsidy of half of BMTA bus fares.

- **Inflation had been high in the previous year**, especially for those of processed food (at and away from home) which increased continuously and reached a historical high following the upsurge in raw food prices at that time. In May and June 2008, prices of processed food increased from the previous month by 1.2 and 2.5 per cent respectively, compared to the 2004-2007 average of only 0.1 per cent. Processed food prices had remained quite stable since end-2008.

2. Underlying inflation indicators

In order to monitor price pressure developments more effectively, the MPC also considered other underlying inflation indicators, for example, (1) an inflation indicator which discarded temporary government measures that affected prices of goods and services, such as the “6 measures in 6 months” and 15-year free education programs, and (2) trimmed mean inflation which was constructed by removing goods and services with extreme price changes from the CPI basket. These underlying inflation indicators helped give a better picture of inflation trends and price pressures so that the MPC would be able to respond appropriately.



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

Although these underlying inflation indicators had been trending downwards since 2008 Q4, with a sharp deceleration in 2009 Q2 due to the high-base effect, they remained positive, which indicated that the fall in the general price level of goods and services did not signify deflation. While it was possible that these indicators could dip below zero in 2009 Q3, the high-base effect would be predominantly responsible. Going forward, the probability of deflation occurring would decline further, as prices of oil and commodities had started to trend upwards. Furthermore, the expected recovery in domestic demand towards the end of the year would not reduce pressure on prices and could cause the public's inflation expectation to increase.

3. When will core inflation return to the target range?

On 14 July 2009, the Cabinet approved the extension of the 5 measures from July 2009 to December 2009. As a consequence, core inflation was projected to turn positive later than previously anticipated, as prices related to the 5 measures would adjust back to their normal levels in January 2010 instead of July 2009. Although the extension of the 5 measures would not further suppress core inflation, effects from the 15-year free education program together with the high-base effect in the previous year led the MPC to assess that there was a high probability that average core inflation in 2009 Q3 would continue to be negative. The MPC expected core inflation to return to the target range in 2009 Q4, with quarterly average of around zero before turning positive in early 2010, as the effects of the government measures and high base started to fade out.