

## How will government policies affect inflation forecasts?

Inflation forecasts are essential for monetary policy deliberations, and also serve as the MPC's prime communication tool to help anchor the public's inflation expectations. The MPC focuses particularly on "underlying" price pressures that reflect the dynamics of price adjustments largely driven by demand factors and private sector's inflation expectations, both of which respond to monetary policy and thus are of high significance. When considering inflation forecasts, the MPC needs to concentrate on these true underlying pressures by separating out the effects of temporary factors. The MPC also needs to explain these short-lived impacts clearly to ensure sound public understanding of the MPC's policy decisions.

Over the periods ahead, government policies will be key factors affecting inflation forecasts. Some policies would likely lead to a one-time jump in the price level, which could substantially affect the calculation of inflation over the projection period. These policies need to be analyzed carefully to ensure a proper assessment of underlying inflation pressures. Key government policies already incorporated into the baseline projection include:

Chart 1 The effect of an increase in minimum wage and civil servants' salary

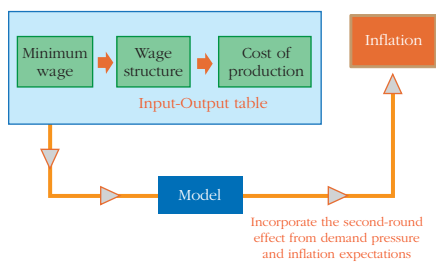
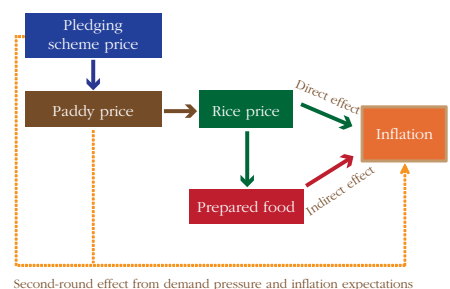


Chart 2 The effect of the rice pledging scheme



**1. Minimum wage and civil servants' salary raise.** A drastic increase in minimum wage and civil servants' salary - roughly by 40 and 30 percent, respectively, will lead to adjustments in the overall wage structure, under the assumption that higher-paid workers receive a lower increase in their wage. Because labor productivity cannot keep up with such an abrupt wage hike, additional cost pressures will result. Based on the input-output table analysis, production costs are expected to rise by 4 percent as a result of this policy.

At the same time, the wage raise will also increase purchasing power, thus stimulating consumption and adding more to demand pressures, with possibly some impacts on short-term inflation expectations as well. Taking all these factors into account, this policy should drive up headline and core inflation in 2012 by about 0.2 and 0.3 percent, respectively.

**2. Rice pledging scheme.** The pledged price has been set to about 50 percent higher than the market price, with possibility that the government will pursue this policy without any quota restriction. The pledging scheme will drive up domestic paddy prices and affect prices of packaged rice directly, which in turn will pressure inflation to the upside through rising costs of prepared food.

Furthermore, the scheme should give rise to greater demand pressures through higher farm income, and also affect inflation expectations in the same manner through the raise of the minimum wage and civil servants' salaries. On the whole, this pledging scheme is expected to drive up headline and core inflation in 2012 roughly by 0.4 and 0.3 percent, respectively.

**3. Energy policy.** While the excise tax on diesel fuel is scheduled to terminate at the end of 2011 and the oil fund levy to end in 2012, the baseline projection assumes that oil fund levy will rise gradually starting from mid-January 2012 onward. The resulting increase in retail oil prices will drive up core inflation indirectly through higher costs of production and transportation, especially public transport fares. This energy policy accounts for 0.7 and 0.2 percent of headline and core inflation forecasts in 2012, respectively, under the baseline scenario.

**4. Free fares for third-class trains and BMTA's non-air-conditioned buses.** In accordance with the cabinet's approval, this measure has been extended to mid-January 2012. However, the baseline projection assumes the measure to be extended throughout the projection period, resulting in a drop of 0.4 and 0.6 percent in headline and core inflation, respectively (compared to the case of no extension).

**Table: The impact of government policies on inflation in 2012**

	Headline inflation	Core inflation
Minimum wage and civil servants' salary raise	0.2	0.3
Rice pledging scheme	0.4	0.3
Diesel tax and gradual increase in oil fund levy	0.7	0.2
Free fares for third-class trains and BMTA's buses	-0.4	-0.6

Taking into account the impacts of these government policies, inflation forecasts for 2012 are higher than previously projected. But barring the effects of these policies, underlying inflation pressures are slightly lower this time because of softened cost pressures, in line with lower commodity prices due to heightened risks from the global economy.