

## **Signs of Rising Inflation Expectations**

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IN THE first two months of this year, headline inflation averaged 3.9 per cent, accelerating from 1.9 per cent in the previous quarter. Such an acceleration may lead casual observers to question the Bank of Thailand (BoT)'s latest decision to keep the policy interest rate unchanged, particularly in light of last week's decision by Bank Negara Malaysia to increase its policy rate despite a milder upward inflation trend.

A closer look at the components of the consumer price index reveals that the 3.9 per cent inflation figure owed much to the spike in fresh food prices and the base effect from oil prices. The less volatile underlying core inflation, which is the BoT policy target, remained low at 0.5 per cent.

Nevertheless, if they wait for a strong core inflation number before reacting, it will be too late for central banks whose mandate is to maintain long-term price stability, typically defined as low and stable inflation, to get things under control. This is because it takes more than a year for monetary policy to have significant effects on inflation. In other words, effective monetary policy needs to be forward looking.

Among the major determinants of future inflation is inflation expectations. A rise in inflation expectations plays a prominent role in household and business decisions, from consumption and investment to wage and price setting. This is why modern central banks pay so much attention to them. Indeed, the origin of the "inflation target" adopted by a number of central banks is to serve as a guidepost for the public's inflation expectations.

In general, inflation expectations can be gauged from three broad sources of information: surveys among economic agents (consumers or businesses); surveys among professional forecasters; and price data of financial products linked to inflation.

In the case of Thailand, the BoT tracks short-term (one-year) inflation expectations with our own monthly business sentiment survey and longer term inflation expectations with government-bond implied forward curves together with the "Consensus Economics" survey. At present, these indicators remain moderate, but there are signs of upward trends.

In particular, January's business sentiment survey showed that the figure for respondents who expected inflation to be 2-4 per cent in the next year was 60 per cent, up from 40 per cent in 2009's quarter-four survey. In contrast, the number of respondents who expected inflation to be less than 2 per cent dropped remarkably to a mere 5 per cent.

While the rise in short-run inflation expectations does not necessarily imply an increase in long-run inflation expectations, should such expectations directly transmit to the process of price and wage settings, inflation outlook could eventually rise. This is due to the fact that prices and wages can not be adjusted frequently and therefore the price- and wage-setters have to make the effort to translate their views on future inflation to their current setting schemes.

As inflation expectations are determined by current inflation, perceived inflation (personal inflation rate) as well as cost-push and demand-pull factors, the recent rise in food and energy prices along with the firming economic recovery therefore pose an additional upside risk to the inflation outlook.

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**(The views expressed are the author's own.)**

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