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Excellency,

No. BOT.MPD.(02) 57/2563 Explanations for average headline inflation in 2019 and the forecast of average headline inflation over 12 months ahead breaching the lower bound of the monetary policy target

According to the Memorandum of Understanding between the Monetary Policy Committee (MPC) and the Minister of Finance dated November 23, 2018, the annual average headline inflation of 2.5 ± 1.5 percent was agreed upon as the monetary policy target for the medium-term horizon as well as the target for 2019. It is incumbent on the MPC to write an open letter to the Minister of Finance, should headline inflation breach the target. In addition, the new monetary policy target that was agreed in the Memorandum of Understanding dated December 6, 2019 specifies headline inflation within the range of 1-3 percent as the target for the medium-term horizon and the target for 2020. According to this latest Memorandum, the MPC is now required to send an open letter to the Minister of Finance, if average headline inflation in the past 12 months or a forecast of average headline inflation over 12 months ahead breach the target range.

On January 2, 2020, the Ministry of Commerce released headline inflation in December 2019 at 0.87 percent. This resulted in an annual average inflation rate of 0.71 percent for 2019, which is below the lower bound of the monetary policy target. Furthermore, based on the *Monetary Policy Report* as of December 2019, the projection for average headline inflation over 12 months ahead (January-December 2020) stood at 0.8 percent, which breaches the lower bound of the monetary policy target for 2020. Consequently, in accordance with the above Memorandum, this open letter shall explain (1) reasons why headline inflation breached the lower bound of the target; (2) the expected time frame for the return of headline inflation to the target; and (3) monetary policy actions aimed at returning headline inflation to the target within an appropriate time horizon. Details are as follows.

Explanations why headline inflation in 2019 and the forecast of average headline inflation over 12 months ahead (January-December 2020) were below target

The annual average headline inflation for 2019 stood at 0.71 percent, declining from the previous year's outturn of 1.07 percent, and hence staying below the lower bound of the monetary policy target. This was mainly stemmed from (1) energy inflation that turned negative and (2) a decline in core inflation given the limited demand-pull inflationary pressures and the waning effects of excise tax increases on tobacco in 2017, which only

resulted in temporarily higher inflation. Nevertheless, fresh food inflation rose from the previous year, as prices of vegetables and fruits increased, while pork and egg prices improved on the back of reduced supply. Key developments that resulted in headline inflation in 2019 lower than the monetary policy target are discussed below.

(1) Supply-side factors, especially falling energy prices, were a major source of the decline in headline inflation. Domestic retail oil prices decreased in line with global crude oil prices, together with the strengthening of the baht that reduced costs of oil imports from abroad. Dubai oil prices in 2019 averaged at 63.51 U.S. dollars per barrel, declining from the previous year's average of 69.65 U.S. dollars per barrel. At the same time, the value of the baht in 2019 averaged at 31.05 baht per U.S. dollar, an appreciation from 32.32 baht per U.S. dollar in 2018. Furthermore, the Oil Fund also attempted to stabilize domestic retail oil prices, thereby limiting increases in domestic prices in times of heightened global oil prices. These factors prompted energy inflation in 2019 to fall from the previous year to -2.68 percent.

Moreover, supply-side factors also put significant downward pressures on core inflation. The dissipating effects from excise tax increases on tobacco during the fourth quarter of 2017 resulted in the decline in inflation rates of tobacco and alcoholic beverages. Meanwhile, increases in fresh food prices did not have much influence on inflation rates of processed food due to a number of factors. First, sellers made adjustments by changing or reducing the quantity of raw material in order to trim down production costs. Second, prices of liquefied petroleum gas (LPG) had been fixed by the government since May 2018. Third, fresh food prices, particularly pork prices, began to decrease somewhat during end of 2019.

(2) On the demand side, the economic slowdown in part led to the decline in core inflation. The Thai economy was adversely impacted by the contraction of merchandise exports in the light of the slowdown in global trade volume and trading partners' economies. Furthermore, subdued exports started to affect household income and employment. Businesses, therefore, faced difficulties in raising prices of goods and services. Instead, they launched promotion more frequently and aggressively so as to boost up sales, which subsequently resulted in declines in core inflation.

(3) Structural changes contributed to the persistently low inflation. Such changes included technological advancements, which boosted production and reduced its costs. In particular, advancements in the production of oil and electronic products (such as electrical appliances, computers, and mobile phones) rendered these products cheaper than in the past. Meanwhile, an expansion of e-commerce reduced distribution costs of goods and services and fostered greater price competition, thereby limiting entrepreneurs' pricing power.

Apart from these, the aging society contributed to the decline in overall demand for goods and services, since the elderly, normally receiving lower income after retirement, constituted a larger share of the entire population. The working-age population at the same time would increase savings to prepare for retirement, thereby lowering household spending on average. All these structural changes were indeed global phenomenon, leading to lower inflation globally as well as in Thailand.

Looking ahead, the MPC assessed that headline inflation in 2020 would average at 0.8 percent, which was lower than the new monetary policy target. The breach of target would be driven by supply-side pressures that would remain low, since a gradual global economic recovery continued to weigh on global energy prices. However, energy prices would likely be volatile due to tensions in the Middle East. Although fresh food inflation would decelerate somewhat given a high base in 2019, it would continue to remain at a high level from the previous year partly owing to volatile weather conditions that might affect supply of certain agricultural products, and vanishing of excess supply of swines and eggs. Meanwhile, demand-pull inflationary pressures would gradually increase on the back of economic recovery and raise core inflation in the period ahead. Nevertheless, the structural factors mentioned above would continue to contribute to persistently low inflation.

(Unit: percentage changes from the same period last year)	Historical average (2010 – 2014)	2015-2017	2018	2019	Forecast 2020
Headline inflation (100%)	2.84	-0.02	1.07	0.71	0.8
Fresh food inflation (15.69%)	6.47	0.60	-0.63	4.21	n.a.
Energy inflation (11.75%)	5.77	-5.63	5.66	-2.68	n.a.
Core inflation (72.56%)	1.61	0.78	0.71	0.52	0.7
- Food component (20.45%)	3.94	1.17	1.20	0.91	n.a.
- Non-food component (52.11%)	0.73	0.64	0.52	0.36	n.a.

Note: Figure in () denotes share of corresponding category of goods and services in the market basket at base year 2015.

Source: Ministry of Commerce and calculations by the Bank of Thailand

The expected time frame for a return of headline inflation to target

Although the projection for headline inflation in 2020 remained lower than the lower bound of the target range, the MPC anticipated that headline inflation would revert to the target range during the second half of 2021. Demand-pull inflation pressures would gradually rise thanks to the continued monetary policy accommodation, which helped bolster Thailand's economic recovery and increase core inflation. At the same time, pressures from the supply side would pick up, as fresh food prices were expected to remain at a high level. Nevertheless, the MPC assessed that high volatilities of both fresh food and energy prices due to tensions in the Middle East and the impact of

the drought in Thailand, as well as large uncertainties in global economic growth, stemming from trade protectionism and geopolitical risks, were key risk factors that could cause headline inflation in the period ahead to deviate from the baseline projection.

Monetary policy implementation to support the return of headline inflation to target over an appropriate time horizon

Under the flexible inflation targeting framework, the MPC primarily aims to fulfill the medium-term price stability objective, while also seeking to attain full-potential economic growth and preserving the country's financial stability. Hence, in order to support the fulfillment of inflation target, monetary policy formulation takes due consideration of the size and source of shocks that affect inflation, the prevailing economic context and outlook at the time, as well as financial stability so that appropriate policy actions are taken to ensure that inflation will return to target within an appropriate time horizon.

The MPC viewed that monetary policy accommodation over recent periods helped in part facilitate the economic expansion and the return of headline inflation to target. However, over the course of the previous year, the Thai economy was projected to grow at a lower rate than the initial projection and below its potential. This was mainly attributed to merchandise exports that contracted and would recover at a slow pace given the slowdown in global trade volume triggered by trade protectionism. Such decline in exports then weighed on employment and domestic demand. In addition, headline inflation was projected to stay below the lower bound of the monetary policy target. The MPC, therefore, voted to cut the policy rate by 0.25 percentage point from 1.75 to 1.50 percent in the fifth MPC meeting of 2019, and undertook another cut of 0.25 percentage points to 1.25 percent in the seventh MPC meeting of the year, so as to facilitate sufficiently accommodative financial conditions conducive to economic growth and the return of inflation to target.

The MPC stands ready to use various tools, ranging from the policy interest rate to microprudential and macroprudential measures, in an integrated and appropriate manner to achieve the monetary policy objectives most effectively, particularly to address financial stability risks going forward given the weakening economic outlook and the prolonged low interest rate environment. Over recent periods, the implementation of the loan-to-value (LTV) measure helped curb risks in real estate markets to some extent. Such mitigated risks were reflected by delays in new project launches by developers and real estate price indexes that were relatively stabilized overall. Moreover, financial institutions tended to be more cautious in underwriting mortgages, particularly second and subsequent mortgages extended to existing borrowers. However, there remain some pockets

of risks that warrant continued monitoring, including debt servicing capability and the search-for-yield behavior that could lead to underpricing of risks.

Furthermore, the MPC has closely monitored the impact of exchange rates on the export sector given heightened external risks that in part lessened inflationary pressures. The Bank of Thailand recently implemented various measures to slow down baht appreciation. The first of these was purchases of the U.S. dollars at appropriate time to strike a balance between the U.S. dollar buying and selling transactions within foreign exchange markets. Such intervention was reflected in the significantly larger quantity of international reserves over recent periods. Second, several measures were enhanced to prevent baht speculation, including (1) a reduction in the daily limit on the outstanding balance of the Non-Resident Baht Account (NRBA) and the Non-Resident Baht Account for Securities (NRBS) to reduce channels conducive to baht speculation, and (2) increases in the reporting requirements for non-residents' holdings of debt securities to enable close monitoring of foreign investors' behavior. Third, the Bank of Thailand further relaxed rules to facilitate capital outflows and hence lessen pressures on the baht. Such revised rules were aimed at (1) allowing exporters to keep their proceeds abroad without the need to repatriate the funds to Thailand, (2) facilitating investment in foreign securities by retail investors, (3) promoting more freely outward transfers, and (4) allowing settlement of gold trading in foreign currencies. The Bank of Thailand also worked in collaboration with related organizations to reduce the large current account surplus, which was considered a structural problem, such as by promoting investment and imports, particularly investment in digital infrastructure.

Looking ahead, the MPC views accommodative monetary policy should be maintained for some time so that overall financial conditions remain conducive to economic growth, which will facilitate the return of headline inflation to target, and at the same time takes into consideration financial stability risks. In particular, the prolonged low interest rate environment could lead to the build-up of risks that pose vulnerabilities to the financial system in the period ahead. The MPC will monitor developments of growth, inflation, and financial stability, together with associated risks, particularly those stemming from trade protectionist measures and geopolitical tensions, as well as closely monitor and assess the impact of structural factors on inflation dynamics. The MPC will stand ready to utilize available policy tools to ensure that headline inflation will revert to the target range in an appropriate time horizon and that the public's medium-term inflation expectations are well-anchored, while at the same time supporting economic growth and preserving the country's financial stability.

According to the latest Memorandum of Understanding between the MPC and the Minister of Finance, the MPC will write an open letter to the Minister again six months

from now, if at that time average headline inflation over the past 12 months or the forecast of average headline inflation over 12 months ahead remain outside the target range. To enhance transparency and clarity of our communication with the general public, the MPC wishes to publish this letter on the BOT's website.

Yours sincerely,

(Mr. Veerathai Santiprabhob)

Governor

Chairman of the Monetary Policy Committee

The Honorable Mr. Uttama Savanayana
Minister of Finance
Bangkok