



January 6, 2017

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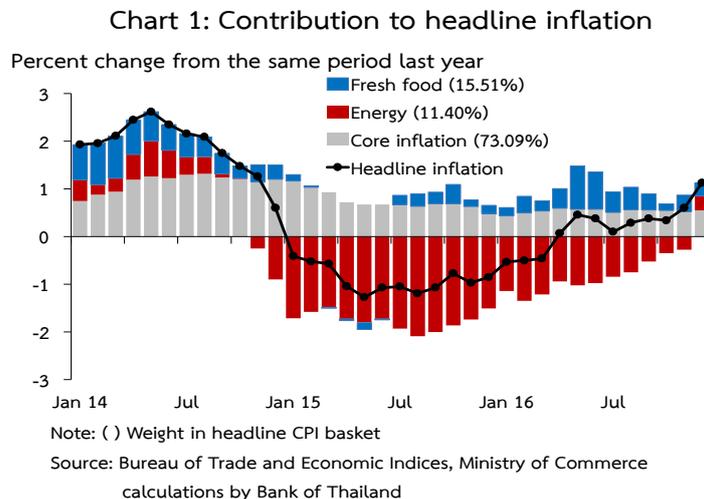
No. BOT.MPD.(21) 19/2560 Explanations for the movements of average headline inflation in 2016 breaching the lower bound of the inflation target

According to the Memorandum of Understanding between the Monetary Policy Committee (MPC) and the Ministry of Finance dated December 14, 2015, the annual average headline inflation of 2.5 ± 1.5 percent was agreed upon as the monetary policy target for 2016 as well as a target for medium-term horizon. Should headline inflation breach the target, it is incumbent on the MPC to explain the reasons of the deviation, the appropriate monetary policy response, and the expected time frame of inflation returning to the target.

Headline inflation for December 2016, disclosed by the Ministry of Commerce on January 4, 2017 registered at 1.13 percent. This resulted in an overall annual inflation rate of 0.19 percent for 2016, which is below the lower bound of the target. Consequently, in accordance with the above Memorandum, I am writing this open letter as Chairman of the MPC to describe: (1) the reasons why headline inflation breached the lower bound of the target; (2) the outlook for headline inflation and the expected time frame for headline inflation returning to the target; and (3) policy actions aimed at returning the headline inflation to the target within an appropriate time horizon. Details are as follows.

Explanations why headline inflation was below the target

The annual average headline inflation for 2016 registered at 0.19 percent, which is higher than the previous year rate of -0.90 percent. Headline inflation turned positive in April 2016 and gradually rose until returning above the lower bound of the target band of 1.0 percent in December 2016 (Chart 1). Nevertheless, it has been two consecutive years in which the



annual average headline inflation remained below the lower bound of the target. The reason for the below-target inflation continued to be supply-sided factors especially energy and fresh food prices which accounted for 79 percent of the difference between the average headline inflation for 2016 and its historical average (Table 1). Key developments are discussed below.

**Table 1: Contributions to headline inflation in 2016, compared with the 2000-2014 average, classified by categories in the headline CPI basket**

	Historical average (2000 – 2014) <sup>1/</sup>	2015	2016	Difference between contribution in 2016 and the historical average <sup>2/</sup>
<b>Headline inflation</b> (Unit: Percent change from the same period last year)	2.58	-0.90	0.19	-2.39 (100)
<b>(Contribution to headline Inflation)<sup>3/</sup></b> (Unit: Percent)				
Energy	0.74	-1.76	-0.77	-1.51 (63)
Fresh food	0.80	0.11	0.41	-0.39 (16)
Core inflation	1.04	0.75	0.55	-0.49 (21)

Note: 1/ Calculated over the period during which Thailand adopted inflation targeting as its monetary policy framework until the period before structural changes in global crude oil prices

2/ figure in ( ) is percent of difference between contribution in 2016 and the historical average

3/ The sum of contribution to the three categories equals to headline inflation for that period

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

**(1) Falling energy prices were a significant contributing factor to low headline inflation.** The average Dubai crude oil price fell from 50.8 U.S. dollars per barrel in 2015 to 41.4 U.S. dollars per barrel in 2016. This was due to a high level of global excess supply as a result of structural shifts in the global supply of crude oil, including technological advancements in shale oil which make crude oil production cost considerably cheaper. Meanwhile, global demand for oil extraction remained subdued, in line with the pace of global recovery. Despite the increase of crude oil prices in the fourth quarter of 2016 after the Organization of Petroleum Exporting Countries (OPEC) reached a preliminary agreement to curtail oil production, it could not fully offset the effect of low crude oil prices during the first half of 2016. As such, lower average crude oil prices in 2016 led to a decline in domestic energy prices, particularly the retail petrol prices, which is the main cause for headline inflation breaching the lower bound of the target. The decline in energy prices throughout 2016 accounted for 63 percent of the difference between the average inflation rate in 2016 and its historical average.

**(2) Fresh food prices increased from 2015, but its growth rate remained low compared with the historical average.** Prices of fresh food rose from the previous year due to supply reduction in several items including vegetables, fruits and meats as a result of drought starting since late 2015. Nonetheless, the growth rate of fresh food prices remained low

compared to the historical average and accounted for 16 percent of the difference between the average inflation rate in 2016 and its historical average.

**(3) Demand pressures remained subdued.** Core inflation expanded at a slower pace than the previous year, in line with a weak demand-side inflationary pressure. While the Thai economy has steadily recovered, the pace of the recovery has been rather gradual due to (1) contraction of merchandise exports given weaker growth in trading partners' economies and (2) weakening household purchasing power due to falling farm prices and a high level of household debt. The weak economic backdrop also limited pricing power of firms to raise prices of goods and services. The core inflation explained 21 percent of the difference between the average inflation rate in 2016 and its historical average.

### **The headline inflation outlook and the expected time frame for achieving the target**

As reported in the December 2016 Monetary Policy Report which was published on December 30, 2016, the MPC projects the annual average headline inflation to be 1.5 percent in 2017. This reflects a gradual increase in headline inflation supported by higher crude oil price projection for 2017 as a result of projected OPEC agreement to curtail oil production as well as due to the base effect of low oil prices in the previous year. In addition, gradual pressure from increasing demand from ongoing economic recovery, will allow greater degree of upward price adjustment of goods and services compared to the previous year. The MPC assesses that headline inflation would gradually attain the midpoint of the target within the next two years. Nevertheless, uncertainties surrounding crude oil prices are the key risk factor that can cause inflation to deviate from the baseline projection.

At the meeting on December 7, 2016, a mutual consensus was reached between the MPC and the Ministry of Finance to keep the headline inflation target of  $2.5 \pm 1.5$  percent as the target for the medium-term horizon and as a target for 2017. This is to reinforce our commitment to attain the monetary policy target and to reassure the general public that the MPC will take necessary policy actions to return headline inflation to the target within an appropriate time horizon without jeopardizing growth and macro-financial stability. The proposed monetary policy target was approved by the Cabinet on December 20, 2016.

### **Returning headline inflation to the target within an appropriate time horizon**

Under the flexible inflation targeting framework, the MPC aims at supporting the economy to achieve full potential, together with maintaining price and macro-financial stability. During 2016, the MPC continued to provide accommodative monetary conditions, aiming at fostering economic recovery and returning headline inflation to the target. The

MPC assesses that the Thai economy continue to expand, but continued to face with several downside risks ranging from uncertainties in the global economic recovery, concerns over the Chinese and European financial sectors, low commodities' prices, and geo-political risks. Although headline inflation rose gradually in line with the MPC projection, the timing that headline inflation would return to the target was postponed due to development in global crude oil prices and domestic fresh food prices. In addition, overall monetary conditions remained accommodative and supportive to the ongoing economic recovery. This is evidenced by low level of real interest rate and bond yields which will help headline inflation return to the target within an appropriate time horizon. Meanwhile, the public's medium-term inflation expectations remained near the target midpoint as reflected by the five-year expected inflation of 2.5 percent based on professional economist opinion's latest survey. The MPC viewed that maintaining the policy rate at 1.5 percent would also help preserve policy space to provide additional support to the economic recovery in event of possible economic shocks and uncertainties including political risks from abroad and the fragile global economic recovery.

Looking ahead, the MPC sees the need for monetary policy to continue its current accommodative stance to support the ongoing economic recovery, which would help return headline inflation to the target. The MPC would continue to closely monitor factors affecting inflation and stand ready to take appropriate tools and policy actions in order to attain the target over an appropriate time horizon and to keep the public's medium-term inflation expectations in check, while maintaining the country's financial stability.

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. Apisak Tantivorawong  
Minister of Finance  
Bangkok