BANK OF THAILAND

Unofficial Translation

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Excellency,

No. BOT.MPD.(02) 688/2563 Explanations for average headline inflation in the past 12 months and the forecast of average headline inflation over 12 months ahead breaching the lower bound of the monetary policy target

On December 6, 2019, the Minister of Finance and the Monetary Policy Committee (MPC) mutually agreed to set the monetary policy target for price stability such that the headline inflation is to reside within the range of 1.0 – 3.0 percent for the medium-term horizon and for the year 2020. The agreement also designated the MPC to write an open letter to the Minister of Finance should the average headline inflation in the past 12 months or a forecast of average headline inflation over the next 12 months breach the target range.

On July 3, 2020, the Ministry of Commerce issued a statement indicating that the June 2020 headline inflation stood at -1.57 percent. This then resulted in a below-the-target average inflation rate of -0.31 percent in the past 12 months (July 2019-June 2020) while the projection for the average headline inflation over the next 12 months (July 2020-June 2021) based on the *Monetary Policy Report* as of June 2020 stood at -0.9 percent, also below the lower bound of the monetary policy target for the year 2020. Abiding by the above Memorandum, this open letter by the MPC shall explain (1) reasons for the headline inflation breaching the lower bound of the target; (2) the expected time horizon for the headline inflation to fall within the target range; and (3) monetary policy actions taken to guide the headline inflation into the target range at an appropriate time. Details are as follows.

Reasons why the average headline inflation in the past 12 months (July 2019-June 2020) and the forecast of the average headline inflation over the next 12 months (July 2020-June 2021) resided below the target

The COVID-19 pandemic during the first half of 2020 prompted government in various countries, including Thailand, to implement the containment measures, which, as a consequence, had unprecedentedly disrupted global economic activities. These actions have resulted in a striking contraction of the global and the Thai economic growth in 2020, with high uncertainties surrounding the length of time needed for a marked recovery. The COVID-19 outbreak has had notable impacts on the Thai economy, particularly on tourism and merchandise exports, which were in turn affected by a sharp deterioration of demand from trading partners as well as supply chain disruptions. Meanwhile, private consumption was dampened by the slowing domestic economic activities due to the containment measures and higher unemployment. In addition, the Thai economy will have to cope with some structural changes once the spread of COVID-19 is contained.

The changing global and Thai economic environment as a result of the COVID-19 outbreak substantially affected the Thai inflation in the recent periods. The average headline inflation in the past 12 months (July 2019-June 2020) stood at -0.31 percent, declining from the outturn of 1.04 percent over the same period last year, and hence staying below the lower bound of the monetary policy target. This was mainly contributed by (1) the energy inflation which continued to be in a negative territory with a declining trend and (2) a decrease in core inflation given dampened demand-pull inflationary pressures as a result of the larger-than-expected contraction of the Thai economy. On this note, the MPC assessed that the Thai economy would contract 8.1 percent in 2020, much worse than the pre-COVID assessment of a 2.8 percent expansion. In addition, the decline in core inflation was attributed to government measures aimed at alleviating the costs of living for households during the COVID-19 outbreak. Nevertheless, fresh food inflation rose from the same period last year, as prices of vegetables, fruits and rice increased on the back of reduced supply. The detailed discussion regarding key factors contributing to the average headline inflation in the past 12 months being below the monetary policy target is presented as follows.

(1) Supply-side factors, especially falling energy prices, were a major source of the decline in the headline inflation. Domestic retail oil prices fell markedly in line with the global crude oil price crash. This was driven by heightened oversupply concerns following lower oil demand owing to the COVID-19 outbreak as well as tougher competition among major oil producers both on prices and production volume in early 2020. Dubai oil prices from July 2019 to June 2020 registered the average of 51.1 U.S. dollars per barrel, declining from the average of 68.2 U.S. dollars per barrel over the same period last year. Furthermore, the government also implemented measures to reduce costs of living for households during the COVID-19 outbreak, such as lowering electricity cost for three months as well as managing the prices of domestic retail oil and liquefied petroleum gas (LPG) through the oil fund. These factors prompted the average energy inflation in the past 12 months to fall by -8.95 percent compared to the same period last year.

(2) On the demand side, the dampened global and Thai economic activities, stemming from implementing the containment measures, mainly led to the decline in core inflation. Merchandise exports and tourism contracted due to a recession in trading partners' economies and the containment measures employed worldwide, thereby reducing employment as well as household income and eventually translated to deteriorating consumer purchasing power. This weakening demand then led to excess production capacity in many industries, making it difficult for businesses to raise prices of goods and services. Furthermore, businesses also launched promotions to boost up the household spending, in line with the government policies encouraging business sectors to help ease the cost of living for households during the outbreak.

(3) Structural changes also contributed to the persistently low inflation. The spread of COVID-19 has created additional disinflationary pressures as a result of altered producer and consumer behaviors. These behaviors include (1) an accelerated expansion of e-commerce, as entrepreneurs and consumers employed more online platforms for goods and services during the COVID-19 containment period, and (2) a greater use of automation in the production process after the COVID-19 outbreak to reduce the risk of virus spreading among workers, with an additional benefit of lowering the production cost. All these structural changes put more downward pressures on inflation, in addition to other existing structural changes, such as an aging society.

Looking ahead, the MPC assessed that headline inflation would remain at a low level for a certain period of time, with high uncertainty surrounding its path. The MPC's projection of headline inflation over the next 12 months (July 2020-June 2021) would be -0.9 percent on average, which would still be lower than the monetary policy target. The breach of target would be driven by supply-side pressures that would likely remain low, since a slow global economic recovery would continue to weigh on global energy prices. Despite some containment measures being loosen in many countries, social distancing measures would remain in place, resulting in subdued economic activities. In addition, prices of goods would stay at low levels due to excess production capacity in many industries worldwide, following the gradual global economic recovery. However, energy prices going forward would likely be volatile as a result of pending geopolitical risks. Although fresh food inflation would likely decelerate somewhat, given a high base in 2019, it would remain at a high level partly owing to volatile weather conditions, such as the drought that might affect supply of certain agricultural products. Meanwhile, **demand-pull inflationary pressures would steadily improve amid an economic recovery**, thus levitating core inflation in the period ahead. These would be the consequence of ongoing implementation of government measures to shore up the economy and cushion the purchasing power of households adversely affected by the COVID-19 outbreak. Hence, prices of goods and services would increase somewhat should the government and private sector continue to implement measures to reduce living expenses for some time in the future. At the same time, **the structural factors mentioned above would still contribute persistently to low inflation.** The inflation outlook in the period ahead would be highly uncertain due to inevitable structural changes in global economy after the COVID-19 outbreak, trade conflicts and geopolitical risks. These could potentially lead to deglobalization, which could pose significant impacts on the global supply chains and prices of goods.

(Unit: percentage changes from the same period last year)	Historical average (2010 – 2014)	2015-2018	2019	July 2019-June 2020	Forecast 2020	Forecast over 12 months ahead (July 2020-June 2021)
Headline inflation (100%)	**2.84**	**0.25**	**0.71**	**-0.31**	**-1.7**	**-0.9**
Fresh food inflation (15.69%)	6.47	0.29	4.21	3.04	n.a.	n.a.
Energy inflation (11.75%)	5.77	-2.81	-2.68	-8.95	n.a.	n.a.
Core inflation (72.56%)	1.61	0.76	0.52	0.39	0.0	-0.1
- Food component (20.45%)	*3.94*	*1.18*	*0.91*	*0.73*	*n.a.*	*n.a.*
- Non-food component (52.11%)	*0.73*	*0.61*	*0.36*	*0.26*	*n.a.*	*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 projection of negative headline inflation did not imply that Thailand was facing deflation risk at present. First, overall prices of goods and services would not persistently contract. Headline inflation was projected to rise toward target in 2021. **Second, prices of goods and services contracted only in some categories.** Prices of around 70 percent of goods and services in the inflation basket increased or remained stable. **Third, the public medium-term headline inflation expectations remained anchored within target.** According to the most recent survey of professional forecasters in April 2020, five-year-ahead headline inflation expectation was at 1.8 percent. **Nonetheless, the Committee saw a need to monitor and assess whether demand and employment would not become persistently subdued** after the relaxation of the containment measures. The Committee would monitor factors hinged on private consumption and investment including incomes, employment, as well as household and business confidence. The Committee would also continue to communicate with the public regarding the outlook of inflation and deflation risk.

<u>The expected time horizon for headline inflation to revert back to the target</u>

Although the projection for headline inflation over the next 12 months (July 2020-June 2021) remained below the lower bound of the target range, the MPC anticipated that headline inflation would revert back to the target range in the second quarter of 2021. Demand-pull inflation pressures would gradually rise, thanks to the sustained monetary and fiscal policy accommodation supporting Thailand's economic recovery and stimulating the purchasing power of households. At the same time, supply side pressures would pick up owing to the improvement of fresh food and energy prices that were expected to recover along with the commodity prices once the spread of COVID-19 was contained. Nevertheless, the MPC acknowledged that there still were volatilities surrounding the movement of fresh food and energy prices going forward, potentially from drought, geopolitical risks as well as uncertainties regarding the global and Thai economic recovery after the pandemic was controlled. These factors could cause headline inflation in the period ahead to possibly deviate from the baseline projection.

<u>Monetary policy implementation to support the reversion of headline inflation back to target over an appropriate time horizon</u>

To conduct the monetary policy under the flexible inflation targeting framework, the MPC primarily aims to ensure the medium–term price stability objective. At the same time, the MPC also intends to promote sustainable economic growth at its full potential and to preserve financial stability. Hence, in order to conduct the appropriate monetary policy so as to achieve the specified inflation target, the MPC considers the size and source of shocks to inflation, the prevailing economic environment and outlook as well as relevant financial stability issues, to ensure that proper policy actions are taken to support the reversion of headline inflation back to target within an appropriate time horizon.

Prior to the COVID-19 pandemic, the MPC viewed that the accommodative monetary policy had helped facilitate the economic expansion and supported the reversion of headline inflation back to target. However, after the outbreak, the MPC assessed that the overall Thai economy would contract, with financial stability becoming more fragile due to the impact of the COVID-19 pandemic. Merchandise exports and tourism sectors would be affected by the contraction of trading partners' economies as well as the containment measures implemented worldwide. Meanwhile, domestic demand, particularly private consumption, would contract as a result of higher unemployment and the employed containment measures, which significantly dampened economic activities. 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 *three* times in the first half of 2020 from 1.25 at the end of 2019 to 0.5 percent since May 2020**. In addition to these actions, the MPC also supported the reduction of the contribution to Financial Institutions Development Fund (FIDF) from 0.46 percent of the deposit base to 0.23 percent for the next two years. This would reinforce more accommodative financial conditions and decrease financing costs of public and private sectors. Such actions taken also harmonized seamlessly with the fiscal measures already implemented by the government. These holistic set of actions helped alleviate the economic impact of COVID-19 outbreak and facilitated the reversion of headline inflation back to the target within an appropriate time horizon. Furthermore, **the MPC also encouraged the Bank of Thailand to implement measures to support retail borrowers affected by the COVID-19 pandemic and to urge commercial banks to expedite the process of debt restructuring for businesses as well as to ease some crucial financial regulations** . Examples include a loan repayment holiday without affecting the credit history of borrowers as well as the reduction on interest rates and fees. In addition, **the MPC also supported the Bank of Thailand in monitoring**

liquidity and the functioning of the financial markets to ensure stability and efficient functioning of the Thai financial markets, which helped lessen the negative impact on the real economy and financial markets and could also, in turn, guide the inflation back to the target.

Looking ahead, the MPC views that fiscal, financial and credit measures must be closely coordinated in a well-targeted and timely manner in order to effectively prevent liquidity problems of households and businesses from having a widespread impact and to accelerate the much anticipated economic recovery. **The fiscal measures will play a crucial role in supporting the employment and SMEs** in order to facilitate the economic recovery and sustain the potential growth going forward. Meanwhile, **the accommodative monetary policy should be maintained for some period of time to bolster the economic recovery and domestic purchasing power after the COVID-19 spread is under control. Such policy will also facilitate the reversion of headline inflation back to target and reduce financial stability risks stemming from liquidity problems and deteriorating debt servicing capability of households and businesses**. Going forward, the MPC will continue to monitor the development of economic growth, inflation, financial stability and associated risks, particularly those resulting from the impact of the COVID-19 outbreak, while, at the same time, assess the impact of structural factors on inflation dynamics. The MPC will be willing to utilize available policy tools to ensure that headline inflation will revert back to the target range within an appropriate time horizon and the medium-term inflation expectations are well-anchored, while also 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 the average headline inflation over the past 12 months or the forecast of the average headline inflation in the next 12 months remains outside the target range. In addition, to enhance the transparency and clarity of our communication to 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