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Inflation Report January 2002

Mr. Bandid Nijathaworn, Assistant Governor of the Monetary Policy Group, Bank of Thailand announced that the Monetary Policy Committee (MPC) released the January 2002 issue of the *Inflation Report* on 31 January 2002. The *Report* intends to enhance public understanding of the Bank of Thailand's monetary policy stance, with the following key details.

Economic conditions in 2001

In December 2001, the economy showed no signs of weakening compared to the previous month. Manufacturing production remained stable, as improvement in private consumption offset the slight decline in investment. Public expenditure also rose continuously. These domestic demand components sustained the economy despite the export slowdown following sluggish global conditions.

Preliminary data in December 2001 indicated that the economic expansion in 2001 Q4 would exceed the MPC's expectations in the wake of the 11 September 2001 event, where weakened export and tourism activity was expected to dampen economic growth. The Thai economy was estimated to grow 1.5 per cent in 2001, lower than in 2000, due to subdued export growth in light of the world economic slowdown. Nevertheless, domestic demand was the factor supporting Thai economic expansion.

In 2001, economic stability was satisfactory. Core inflation remained at a low level of 1.3 per cent, with headline inflation at 1.6 per cent. Both trade and current accounts continuously recorded a surplus, while foreign debt obligations were on a declining trend. At the end of 2001, international reserves stood at 33 billion US dollars.

Liquidity in the financial sector remained high throughout the year. In 2001, deposits expanded 3.9 per cent, while credits (excluding debt write-offs and loans transferred to AMCs) rose only slightly. On the whole, however, commercial bank performance improved.

Monetary policy stance during November 2001 - January 2002

As core inflation outlook remained within the target range, and external stability was strengthened, the MPC's view on monetary policy stance was on an easing bias for the past 3 months. This was expected to provide a financial environment conducive to business sector growth and economic recovery, and to complement fiscal policy stance. For each policy decision, the MPC considered the following issues.

1. In the meeting on 27 November 2001, the MPC deemed that uncertainty in the global economic recovery called for an accommodative monetary policy that would alleviate the effects of a world recession. However, compared to other countries' real interest rates, the corresponding Thai rate was already at a low level appropriate for economic expansion and stabilization. The MPC thus decided to maintain the 14-day repurchase rate at 2.5 per cent per annum, but stood ready to adjust the policy stance to accommodate any steeper-than-expected slowdown.

2. In the subsequent meeting on 25 December 2001, the MPC continued to focus on global economic uncertainty and possible effects on Thai exports and recovery prospects for

2002. The lower inflation trend that drove up real interest rates and possibly delaying the economic recovery, together with continuous improvement in external stability, prompted the MPC to lower the 14-day repurchase rate by 25 basis points to 2.25 per cent per annum in order to stimulate the economy.

3. In the latest meeting on 21 January 2002, the MPC expected economic growth in 2002 to exceed that of 2001, as the budget for fiscal year 2002 called for an acceleration in public spending, and exports was expected to pick up in line with the global upturn. However, the MPC assessed that uncertainty remained with regard to the world economic recovery in the second half of 2002. As the budget for fiscal year 2003 would dampen the fiscal impetus in order to rein in public debt, monetary policy stance should be eased further to support economic recovery in the second half of the year and to alleviate the fiscal burden in future periods. In addition, an easier stance would facilitate exchange rate adjustments that would not impede exports. On account of core inflation outlook remaining within the target range for the 8 quarters ahead, the MPC decided to reduce the 14-day repurchase rate by another 25 basis points to 2 per cent per annum.

Economic growth and inflation outlook in 2002-2003

Compared to the assumptions used in the economic forecasts 3 months earlier, the MPC deemed that:

1. The Fed funds rate assumption should be adjusted to the current level of 1.75 per cent per annum, lower than previously projected. The Fed was also expected to cut the Fed funds rate

by another 0.25 per cent per annum in 2002 Q1 to stimulate the economy, before raising the rate slightly when the economy picked up in the second half of 2002.

2. The cut in the Fed funds rate was more drastic than previously assumed and would hasten global recovery further. The assumptions on the US and major trading partners' economic growth were thus revised upward.

3. Dubai oil price should average between 18-19 US dollars per barrel in 2002, and 20 US dollars per barrel in 2003, lower than the assumption used in the previous *Report*.

4. The public spending assumption for fiscal year 2002 should be maintained. For fiscal year 2003, however, the injection of public funds was assumed to decrease, given the government's strategy towards achieving fiscal consolidation and stronger fiscal discipline. In 2003, the budget deficit should reach 3.2 per cent of GDP. In addition, the value added tax (VAT) rate increase was postponed to 2003 Q4.

5. The 14-day repurchase rate was assumed constant at 2 per cent per annum throughout the period from 2002 Q1 to 2003 Q4, reflecting an easing of 0.5 per cent per annum from the previous assumption.

Macroeconomic model forecasts under new assumptions and the MPC's judgment warranted the following:

1. The economy should grow slightly faster in 2002 compared to 2001. Supporting factors included improved external conditions, especially the rebound in trading partners' economies, and monetary and fiscal stimuli that should foster the economic recovery. The MPC also deemed that other government economic measures should start to yield positive effects. The MPC thus expected the economy to expand between 2-3 per cent on average in 2002, compared

to the October 2001 projection of 1-3 per cent. The revision in the forecast reflected better economic performance, where the probability of the economy growing less than 2 per cent decreased from 39 per cent to 28 per cent. On the other hand, the probability that the economy would grow between 2-3 per cent increased from 53 per cent to 68 per cent.

2. In 2003, the MPC expected the economy to grow between 2-3.5 per cent on average, with 76 per cent probability. The budget deficit was expected to decrease in fiscal year 2003, which would lessen the fiscal stimulus from 2002 Q4, ultimately leading to a balanced budget. Nevertheless, an easier monetary policy stance adopted since 2001 Q4 through to 2002 Q1, coupled with the global economic upturn, should compensate for the softer fiscal boost. The economy should thus continue to expand in 2003.

3. Throughout the projection period, the MPC perceived no risks that would divert core inflation from the target range. Indeed, core inflation could be on a lower path than previously expected. In 2002, due to the postponement of the VAT rate hike and lower oil prices, core inflation had 72 per cent probability of averaging between 1-1.5 per cent, compared to 13 per cent probability previously. In 2003, core inflation should average between 1.5-2.5 per cent with 79 per cent probability, following the economic upturn and the assumption that the VAT rate would be raised in the last quarter of that year.

The Bank of Thailand will release the eighth issue of the *Inflation Report* at the end of April 2002.

Bank of Thailand

31 January 2002