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Inflation Report April 2002

Mr. Bandid Nijathaworn, Assistant Governor of the Monetary Policy Group, the Bank of Thailand announced that the Monetary Policy Committee (MPC) released the April 2002 issue of the *Inflation Report* on 30 April 2002 to communicate the Bank of Thailand's monetary policy stance to the public. The key details of the *Report* are summarized below.

Current economic and inflation conditions

Preliminary data indicated that Thai economic conditions improved in 2002 Q1, especially with regard to production.Capacity utilization rate rose to 58.4 per cent, in line with continued expansion in private investment, notably in the construction sector. However, a number of risk factors that could hinder economic recovery remained, including 1) the possibility of higher oil prices resulting from tensions in the Middle East, 2) the uncertainty in trading partners' economic recovery, 3) the tapering fiscal stimulus after an acceleration in the first half of fiscal year 2002, as well as the necessity to maintain fiscal discipline that limited any further increase in expenditures, and 4) the inability of the financial sector to fully accommodate business expansion and monetary policy transmission.

Internal economic conditions remained stable. Headline inflation in 2002 Q1 dropped continuously to 0.6 per cent, compared to 1.6 and 1.1 per cent in 2001 Q3 and 2001 Q4, respectively. Core inflation stood at 0.9 percent, slowing down from the previous quarters, in agreement with the MPC's forecast reported in the last *Report*. External financial position remained strong, as reflected by the declining trend of external debt and high level of international reserves.

Monetary policy stance in the last 3 months

In the meetings on 4 March and 22 April 2002, the MPC assessed that the process of economic recovery was taking hold but various risk factors remained, and thus policy in support of the recovery continued to be needed. However, the interest rate cuts in the previous 2 MPC meetings were deemed adequate in signalling the financial markets to adjust in accordance with the monetary policy stance. Although lending rates adjusted more slowly than deposit rates, the larger commercial banks continued to lower both rates. Once commercial banks could sufficiently adjust their financial positions and liquidity management, commercial banks' interest rates were expected to fall further. The MPC thus decided to maintain the 14-day repurchase rate at the previous level of 2 per cent per annum.

Economic growth and inflation projections

Compared to the assumptions used in the previous projection 3 months earlier, the MPC deemed that:

1) Although the Japanese economy continuously contracted, economic developments that saw the US economy bottoming out in 2001 Q4, without posting negative growth in any quarter, warranted an upward revision in the trading partners' growth assumption. Trading partners' growth was expected to turn positive from 2002 Q2 and to average 1.7 per cent for the whole of 2002 compared to 0.9 per cent assumed previously. The marked improvement in the case of the US prompted the MPC to use

the assumption that the Fed would raise the Fed funds rate faster and more drastically than previously assumed, with a 50-basis-point hike in 2002 Q3. The Fed was assumed to increase the Fed funds rate continuously until 2003 Q3.

2) The rising trend in the world economy together with tensions in the Middle East could raise oil prices. Dubai crude oil price was thus assumed to adjust upward to 20-23 US dollars per barrel in 2002, and to average 22 US dollars per barrel in 2003. The new assumption was higher than the previous assumption of 18-19 US dollars per barrel in 2002 and 20 US dollars per barrel in 2003.

3) The assumption on public expenditures for fiscal years 2002 and 2003 remained the same as in the last *Report*. However, the disbursement acceleration in the first half of 2002 implied a smaller injection of funds into the economy in the second half of the year. Also, the assumption in the previous *Report* that the value added tax (VAT) rate would be raised from 7 per cent to 10 per cent in 2003 Q4 was amended, as the hike should not be in effect in the near future. The MPC thus assumed the VAT rate to remain at 7 per cent throughout the forecast period.

4) The 14-day repurchase rate remained at 2 per cent per annum throughout the forecast period.

5) The backward revision of the national account statistics from 1993 onwards by the National Economic and Social Development Board (NESDB), especially in 2000 and 2001, affected the growth rates of the gross domestic product components.

The latest data from the NESDB indicated that the Thai economy expanded at the rate of 2.1 per cent in 2001 Q4 over the same period the previous year, higher than anticipated. The expansion was due to private consumption and private investment growth, reflecting the effects of fiscal stimulation. At the same time, the contraction in export and import was smaller than previously projected, indicating less-than-expected effects of the US terrorist attacks on the Thai economy.

The acceleration in the growth rate in the previous quarter improved consumption and investment trends. The better-than-expected turnaround in trading partners' economies, on the other hand, should improve export trend. As for the rise in oil prices that might hinder world economic expansion, the MPC deemed the rise to reflect stronger oil demand following world economic recovery. The marked oil price increase in April was deemed to be temporary due to tensions in the Middle East. Consequently, external factors were favourable for Thai export recovery. Taking account of internal factors, including monetary and fiscal policies, together with better-than-expected economic data in 2001, the MPC decided to revise the economic forecasts for 2002 and 2003 upward from the previous *Report*. Economic growth for 2002 was forecasted to average 2.5-3.5 per cent with 73.6 per cent probability, while economic growth for 2003 was forecasted to average 2.5-4 per cent with 80 per cent probability.

The MPC expected core inflation to remain low. Although world crude oil and commodity prices rose and domestic demand picked up, inflationary pressure remained minimal. Together with the postponement of the VAT rate hike, the MPC deemed that core inflation would average only 0.5-1 per cent in 2002 before rising to 1-2 per cent in 2003, which would be within the target range for the 8 quarters ahead. Compared with major trading partners' inflation trends, Thai inflation was not too low and was not an obstacle to Thailand's export competitiveness. Low inflation was also supportive of easy monetary policy stance.

Bank of Thailand

30 April 2002