



## BANK OF THAILAND NEWS

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### **Inflation Report October 2004**

Ms. Atchana Waiquamdee, Assistant Governor, Monetary Policy Group, Bank of Thailand (BOT), announced that the Monetary Policy Committee (MPC) released the October 2004 issue of the *Inflation Report* on 28 October 2004. The *Report* was issued to enhance public understanding of the BOT's policy stance, with the key details summarized as follows.

#### **Recent developments in inflation and economic conditions**

The Thai economy expanded 6.3 per cent in 2004 Q2, declining from 6.6 per cent in the previous quarter, due to impacts from the avian flu and an increase in oil prices. For 2004 Q3, the preliminary assessment of economic conditions indicate that the Thai economy was further affected by the gradual increase in domestic oil prices causing some economic activities such as consumer spending to slow down. Strong economic fundamentals along with the country's strong fiscal position, however, will contribute to the sturdy economic growth of the Thai economy. Growths in exports as well as private and public investment are factors supporting the continued expansion.

Overall economic stability remained strong despite the rise in headline and core inflation by 3.3 and 0.6 per cent, respectively, in 2004 Q3, accelerating from the previous quarter. The trend of headline and core inflation should rise further following the higher cost of production, especially from the continued increase in oil price. External stability remained robust with the current account surplus and the higher international reserves, with foreign debt declining.

#### **Economic growth and inflation projections**

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

1) Even though the Fed increased the fed funds rate on 21 September 2004 to 1.75 per cent per annum, extremely high world crude oil prices resulted in an increase in the US inflation rate. While risks to growth of the US economy intensify, the Fed would be more cautious in raising the fed funds rate. As a result, the MPC gradually adjusted the fed funds rate assumption upwards throughout the forecasting period, but at a slower pace for 2005.

2) Dubai crude oil prices rose substantially from the previous assessment due to uncertainties rising from terrorist attacks in various countries and natural disasters.

As a result of the government's decision to float domestic retail benzene oil prices on 21 October 2004 and an inclination to float retail diesel oil prices the beginning of next year, the MPC adjusted the domestic retail oil price assumptions upwards in line with the Dubai oil price assumptions.

3) Trading partners' economies in 2004 improved overall from the previous assessment, especially Japan and Asian region economies.

4) The effect of the avian flu on the economy was higher than expected in April.

Due to changes in the aforementioned assumptions with preliminary projections together with assessments of various risks to the economy in the following periods, such as the growth of trading partners' economies, the rising trend in domestic oil prices, the avian flu, unrest in the southern provinces, plans by the government to reduce taxes, and measures to increase government employee and civil servant's salary, as well as other possible measures by the government to stimulate the economy, the MPC assessed that in 2004 and 2005, the Thai economy would grow at 5.5-6.5 per cent, lower than previously projected, with probability around 92 and 80 per cent, respectively.

With regard to the inflation trend, the MPC assessed risks which could put pressure on prices in the future to include the impact on domestic oil prices from higher world crude oil prices, the effect of the avian flu on food prices, the tightening of the labor market, and the increase in government employee's and civil servant's salary. The MPC thus expected headline inflation in 2004 and 2005 to accelerate to 2.5-3.0 and 3.0-4.0 per cent per annum, respectively. Along with high competition in some businesses, cooperation was requested by officials to maintain prices of goods and services at the current level causing a lag in transmission from headline to core inflation. Core inflation remained the same, averaging at 0.0-1.0 in 2004. For 2005, it was expected that the floating of diesel oil prices along with lower constraints on goods prices will raise core inflation to 1.5-2.5 per cent.

#### Monetary policy stance in the last 3 months

In order to determine the appropriate monetary policy stance going forward, the MPC discussed various important issues as follows:

1. In the Monetary Policy Committee's meeting on 25 August 2004, the MPC viewed that the Thai economy continued to expand favorably driven by exports and private investment. However, the rate of inflation accelerated with a tendency to continue rising due to pressures from higher oil prices, increased production capacity utilization, and tightening labor market. In assessing the risks from higher oil prices on the economy, the MPC believed that increased oil prices would have a greater impact on economic stability than on economic growth, making it less necessary for current interest rates to remain low. Monetary policy should adjust in the direction of maintaining stability within the Thai economy. Therefore, the MPC decided to raise the 14-day repurchase rate by 25 basis points from 1.25 per cent per annum to 1.50 per cent per annum and will continue to closely monitor factors affecting the future path of the economy and inflation, particularly world oil prices.

2. In the Monetary Policy Committee's meeting on 20 October 2004, the MPC viewed that the current economy was affected by the increase in domestic oil prices. Nevertheless, the economy should continue to expand strongly in the following periods despite the risks from oil prices and higher uncertainty in the world economy. Inflationary pressure has risen significantly from oil prices, increased capacity utilization, tightening of the labor market, growth of credit, and the possible rise in commodity prices due to an increase of input costs. The MPC believed that the domestic interest rate should rise to an appropriate level to maintain the stability of the economy with increases occurring gradually. The MPC thus decided to raise the 14-day repurchase rate by 25 basis points from 1.50 per cent per annum to 1.75 per cent per annum and would closely monitor the effects on economic stability and future growth, in order to determine the monetary policy stance consistent with economic conditions.

Bank of Thailand

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