BANK OF THAILAND NEWS
Communications and Relations Office, Management Assistance Department
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No. 12/2005

Inflation Report April 2005

Ms. Atchana Waiquamdee, Assistant Governor, Monetary Policy Group, Bank of Thailand (BOT) announced that the Monetary Policy Committee (MPC) released the April 2005 issue of the *Inflation Report* on 28 April 2005. 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 at a slower rate during the first 2 months of 2005 due to the increase in crude oil prices, the tsunami, the drought, unrest in the south, and the slowdown in the world economy resulting in sluggish private consumption and investment.

With regard to economic stability, the inflation rate for 2005 Q1 slowed down from the previous quarter with headline and core inflation averaging at 2.8 and 0.7 percent, respectively. However, the latest data for March 2005 indicated that the inflation rates accelerated due to the rise in domestic retail oil prices in order to decrease the reliance on the government oil fund, following the increase in world crude oil prices. External stability was characterized by the unusual acceleration of imports as a result of very high crude oil prices as well as the decrease in tourism revenues after the tsunami which could cause the current account for 2005 Q1 to record a deficit. Nevertheless, the current account is projected to record a slight surplus for 2005.

Economic growth and inflation projections

Compared to the assumptions used in the projection 3 months earlier:

1. Dubai crude oil prices was adjusted upwards from the previous assumption and remained high for the projection period following the increase in world crude oil prices and the trend of continued high prices.

The assumptions on higher Dubai crude oil prices along with the trend to float retail diesel prices led the MPC to raise domestic retail oil price assumptions higher than previously assumed.

2. The fed funds rate adjusted upwards more rapidly and vigorously than the previous assumption, higher by approximately 50 basis points per annum towards the end of the projection period.

3. Trading partner economies expanded at a rate similar to that previously assumed.

4. Assumptions on government spending adjusted upwards with the inclusion of the supplementary budget of 50 billion baht. Furthermore, the state enterprise capital expenditure budget was also adjusted upwards.

From initial data for 2005 Q1, which indicated that the Thai economy would expand at a slower rate, along with higher world crude oil prices and domestic retail oil prices than previously assumed were major negative factors that would affect output growth in 2005. However, additional government spending from the supplementary budget of approximately 50 billion baht would help alleviate these negative risks. As a result, the MPC assessed that for 2005 the Thai economy would expand at a slower rate than previously assumed. For 2006, assumptions did not change much from previously assumed with the exception of high world crude oil prices which continued from 2005 and the upward adjustment in the fed funds rate. Hence, Thai economic growth for 2006 was adjusted downwards slightly from the previous projection.

Risks to the economy going forward included positive risk of additional government stimulus measures and negative risks of the rising trend in world oil prices, lower-than-expected growth in trading partner economies, the ongoing and possible expansion of unrest in the southern provinces, and higher-than-expected loss from the drought. These negative risks were larger than previously assumed leading the MPC to assess that the Thai economy would grow slower than previously assumed at approximately 4.5-5.5 percent in 2005 and at 5.5-6.5 percent in 2006 with probability of 80.2 and 64.4 percent, respectively.

The MPC projected that headline inflation in 2005 and 2006 would be higher than previously forecasted following higher than previously assumed world oil prices and Thai farm prices. This could result in increases in price of goods that have not yet been adjusted following higher cost of production due to higher crude oil prices. However, the pressure on prices during this time was mainly attributed to supply side pressure whereas demand pressure was weaker due to the slower economic trend. Thus, although pressure from production costs was expected to eventually have an effect on the consumer basket, weaker demand would limit price increases. Headline inflation was expected to be around 3-4 and 2-3 percent in 2005 and 2006, respectively. While, core inflation was expected to be around 1-2 and 2-3 percent in 2005 and 2006, respectively.

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 2 March 2005, the MPC viewed that the economy may slow down in the short run due to the tsunami disaster and the drought. However, overall, the economy was expected to expand close to the previous projection with government and private investment being the main driving factors. In light of economic stability, the inflation rate should accelerate following higher world crude oil prices and domestic retail diesel prices. With regard to external stability, although the current account recorded a deficit in January 2005 owing to increased imports and the effects from the tsunami, but the impact should be temporary. Upward price pressures were likely to build up going forward as production costs had increased considerably in the recent period. Moreover, with growth remaining firm, higher oil prices were more likely to feed into higher inflation. At the same time, the negative fallout from the tsunami had not been more severe than anticipated in the previous meeting. In this light, the MPC agreed that economic stability and sustained growth in the long term would be strengthened by an upward adjustment of interest rates. The MPC thus decided to raise the 14-day repurchase rate from 2 to 2.25 per cent per annum.

2. In the Monetary Policy Committee's meeting on 20 April 2005, the MPC viewed that the Thai economic growth moderated due to negative effects from higher crude oil prices, the tsunami, ongoing unrest in the southern provinces, and world economic slowdown. With respect to economic stability, the inflation rate accelerated as a result of rising energy prices. span style="mso-spacerun: yes"> Meanwhile, the current account was likely to move into deficit in the first quarter of 2005 in response to abnormally high imports. With the risk of further upward movements in inflation remaining, the MPC deemed that the upward path of the policy rate should be maintained. However, against the background of increased risks to growth from negative factors emanating from both domestic and external sources, especially high oil prices, and without signs of cumulating financial imbalances from unusually low interest rates, policy tightening should be implemented at a gradual pace to ensure that monetary conditions would facilitate the private sector's adjustment to the risks outlined above. The MPC therefore decided to maintain the 14-day repurchase at 2.25 per cent per annum for the time being.

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28 April 2005

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