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Inflation Report July 2006

Ms. Atchana Waiquamdee, Assistant Governor, Monetary Policy Group, Bank of Thailand (BOT) announced that the Monetary Policy Committee (MPC) released the July 2006 issue of the *Inflation Report* on 28 July 2006. 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 from the previous year by 6.0 per cent during 2006 Q1, accelerating from 4.7 per cent growth in 2005 Q4. This reflected the unusually low output growth rate in the previous year due to natural disasters since the economy when seasonally adjusted expanded from the previous quarter by only 0.7 per cent, mainly owing to softening domestic demand, both in consumption and investment. Nevertheless, the export sector continued to expand well. This accelerating growth rate of GDP was consistent with MPC's projection in the previous *Inflation Report*. For 2006 Q2, recent indicators still showed a slowdown in private consumption and investment due to adjustments in response to higher goods prices and production costs. Nevertheless, expansions in the global economy should drive exports and would act as the main engine of growth, going forward.

Overall economic stability was pressured by rising prices. Headline and core inflation for 2006 Q2 averaged at 6.0 and 2.8 per cent, respectively, higher than the average of 5.7 and 2.6 in the first quarter. This reflected not only the impact of increasing prices in both energy and raw food but also the pass-through of these prices to core inflation. Nevertheless, weak domestic demand and continuous increases in the policy rate coupled with the speed-up of monetary policy transmission through the commercial bank interest rate channel helped alleviate some pressure on inflation. Risks, however, remained from more volatile and higher oil prices which could exert pressure on inflation going forward. Financial stability conditions also remained strong for both the corporate and banking sectors. Nevertheless, financial conditions of the household sector, especially in the low-income group, would be closely monitored.

Risks to economic stability going forward could rise from continuously high and volatile oil prices, tightening monetary policy stances in many countries, volatile capital flows, as well as political uncertainty which could affect consumer and investor confidence.

External stability remained satisfactory although the current account was in deficit during April and May 2006, after recording surpluses in the past 3 quarters. This was partly due to the exceptionally high retained earnings and dividend payments to foreign investors. As a result, the net services, income and transfers balance was in deficit for the first time since May 2003. For the trade balance, latest indicators in 2006 Q2 showed that net exports would continue to be the major driver of output growth, owing mainly to continual expansions in Thailand's trading partners' economy. External liquidity was also satisfactory, where the ratio of international reserves to short-term external debt remained higher than 3.

Economic growth and inflation projections

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

1. Dubai oil price assumptions adjusted higher than previously assumed for the entire projection period, averaging at 66.2 and 71.0 US dollars per barrel in 2006 and 2007, respectively. The upward adjustment was in line with continual expansions in world demand for crude oil while the increase in supply was limited.

2. Assumptions on non-fuel commodity prices and world farm prices were revised up from that used in the previous *Inflation Report* for the first part of the projection period before trending down towards the same path in the latter part.

3. The hike in the fed funds rate was expected to end in 2006 Q3 at 5.50 per cent per annum, 50 basis points higher than the assumption used in the previous *Inflation Report*.

4. The growth rate of Thailand's trading partners' economies in 2006 was revised upwards due to higher-than-expected economic expansion in Asia in 2006 Q1 before trending down towards the same path in 2007.

5. The public investment assumption for fiscal year 2007 was revised down somewhat due to the delay in forming up a new government which in turn would delay the budgeting process. Meanwhile, the assumption on government consumption for fiscal year 2007 was higher than that used in the previous *Inflation Report* due to the government's measure to accelerate disbursements of the carry over budget than previously assumed.

Risks to the economy going forward included:

(1) fluctuations in world oil prices owing to supply uncertainty and global demand for oil which was also related to world economic growth

(2) political uncertainty and the amount of time needed for the budgeting process.

The MPC thus assessed that in 2006 the Thai economy would expand around 4.0-5.0 per cent with 92 per cent probability and around 4.0-5.3 per cent with 81 per cent probability in 2007.

Possible upward pressure on inflation in the following periods could come from higher world oil prices, while downward pressure could come from a slowdown in domestic demand which would lessen the second round effect. The MPC thus projected headline inflation for 2006 to be around 5.0-5.8 per cent before declining to 2.5-4.0 per cent in 2007, while core inflation should average around 2.0-3.0 per cent in 2006 and 2007.

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 7 June 2006, the MPC viewed that the Thai economy grew satisfactorily in 2006 Q1. Although latest indicators showed signs of softer domestic demand conditions, higher-than-expected oil prices caused inflation to clearly accelerate beyond the MPC's previous projections. Therefore, the MPC decided to raise the 14-day repurchase rate by 25 basis points from 4.75 to 5.00 per cent per annum.

2. In the Monetary Policy Committee's meeting on 19 July 2006, the MPC viewed that economic growth would slow down in 2006 Q2 and could continue to slow down for some time. Pressure on economic stability remained with oil prices edging up further. Headline inflation in 2006 was therefore likely to moderate at a pace slower than previously projected. However, softening economic growth would help relieve pressure on core inflation, which was still expected to stay within the target range. The MPC thus decided to maintain the 14-day repurchase rate at 5.00 per cent per annum.

Bank of Thailand

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