



# BANK OF THAILAND NEWS

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## **Inflation Report October 2006**

Ms. Atchana Waiquamdee, Assistant Governor, Monetary Policy Group, Bank of Thailand (BOT) announced that the Monetary Policy Committee (MPC) released the October 2006 issue of the *Inflation Report* on 30 October 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 4.9 per cent during 2006 Q2, slowing down from 6.1 per cent in 2006 Q1, mainly due to softening domestic demand in the private sector while external demand remained buoyant, leading to continued high growth in exports of goods and services. When seasonally adjusted, the economy expanded from the previous quarter by 1.0 per cent. This decelerating growth rate of GDP was consistent with MPC's projection in the previous *Inflation Report*. For 2006 Q3, recent indicators showed a slight recovery in private consumption and private investment. However, high oil prices during July and August 2006, political uncertainty as well as southern unrest continued to put pressure on consumption and investment. Nevertheless, export growth remained strong, owing to favourable external demand.

With regard to overall economic stability, inflationary pressure started to subside, with headline and core inflation averaging 3.6 and 1.9 per cent, respectively in 2006 Q3, lower than the respective average of 6.0 and 2.8 percent in the previous quarter. This reflected not only the high base effect from the floating of diesel oil price in late June 2006, but also the downward trend of energy prices and transportation and communication prices, as well as price administration by the Ministry of Commerce. Nevertheless, risks that oil prices could increase and become volatile remained, which could exert upward pressure on inflation going forward. Financial stability conditions remained favorable, despite high oil prices in 2006 Q2, fluctuations in global financial markets due to capital flows, rising interest rates, as well as political uncertainty which delayed activities in the corporate, household, and banking sectors. However, lower risk from moderating oil prices and stable interest rates should support economic activities going forward, especially since the corporate sector already had the potential to invest, while stable costs of living should help improve household's balance sheet.

External stability remained satisfactory with the current account returning to surplus in July and August 2006, after recording a deficit during 2006 Q2. This was due to improvements in the net services, income and transfers balance together with better performance in the trade balance following improvements in exports especially those of agricultural and electronics products. As a result, during the first 7 months of 2006, the current account recorded a surplus of 1.6 billions of US dollars. Moreover, external liquidity remained satisfactory, with the ratio of international reserves to short-term external debt remaining above 3.

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

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

1. Dubai oil price assumptions adjusted lower than previously assumed for the entire projection period, averaging at 62.6 and 61.3 US dollars per barrel in 2006 and 2007, respectively. The downward adjustment was in line with softening world demand for crude oil and increasing crude oil supply.

2. Assumptions on world farm prices were revised up from that used in the previous *Inflation Report* for the entire projection period, mainly due to higher prices of rice and rubber. However, assumptions on non-fuel commodity prices were more or less the same as previously assumed.

3. The hike in the fed funds rate was expected to end and remain at 5.25 per cent per annum until 2008 Q3, 25 basis points lower 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 Europe and some Asian countries in 2006 Q2 before trending down towards the same path in 2007.

5. Regional exchange rates remained in the appreciation trend but were expected to be slightly weaker than that assumed in the previous *Inflation Report* mainly due to the depreciation of the yen. However, regional currencies were expected to become stronger compared to the earlier assumption from the second half of 2007 onwards due to the strengthening renminbi.

6. Assumptions on public consumption and investment for fiscal year 2007 were revised up due to the acceleration of the budgeting process and increased public expenditure in line with the budget deficit.

Risks to the economy going forward included:

(1) fluctuations in world oil prices owing to uncertainty in the supply of and global demand for oil,

(2) slower-than-expected trading partner's economic growth and faster-than-expected slowdown in the electronics cycle which could affect the exports sector, and

(3) improvements in business sentiments due to clearer government policies which should support the domestic investments.

The MPC thus assessed that in 2006 the Thai economy would expand around 4.5-5.0 percent with 81 percent probability and around 4.5-5.5 percent with 80 percent probability in 2007.

Possible upward pressure on inflation in the following periods could come from acceleration in world oil prices and higher-than-expected farm prices due to the flood. Meanwhile downward pressure could come from lower domestic demand from the aforementioned negative risk factors on growth and price administration by authorities. The MPC thus projected headline inflation for 2006 to be around 4.3-4.8 percent before declining to 1.5-3.0 percent in 2007, while core inflation should average around 2.0-2.5 percent in 2006 and 1.5-2.5 percent in 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 6 September 2006, the MPC viewed that the Thai economy continued to expand in the second quarter and July 2006, although at a more moderated pace due to the slowdown in domestic spending. However, export performance remained favorable. Economic stability improved, as evidenced by the decline in inflation and the current account turning positive. The MPC viewed that the current level of the policy interest rate was considered appropriate, and decided to maintain the 14-day repurchase rate at 5.00 percent per annum.

2. In the Monetary Policy Committee's meeting on 18 October 2006, the MPC viewed that the Thai economy continued to expand well. Although domestic demand in the second half of this year softened from the first half, export growth remained robust and economic stability improved. In addition, the decline in inflation was likely to help boost consumers' purchasing power. Consequently, the economy was expected to maintain growth and stability in 2007. The MPC deemed the current level of the policy rate to be appropriate and thus decided to maintain the 14-day repurchase rate at 5.00 per cent per annum.

Bank of Thailand

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