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Communications and Relations Office, Management Assistance Department

Tel. 0-2283-5016-7 FAX 0-2281-5648 www.bot.or.th

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Inflation Report January 2007

Mrs. Suchada Kirakul, Assistant Governor, Monetary Policy Group, Bank of Thailand (BOT) announced that the Monetary Policy Committee (MPC) released the January 2007 issue of the *Inflation Report* on 26 January 2007. 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 by 4.7 percent year-on-year in 2006 Q3, slowing down from 5.0 percent in 2006 Q2, mainly due to a slowdown in domestic demand, particularly private spending which had decelerated by more than the MPC's expectation. At the same time, the growth of exports of goods and services moderated as a result of a high base. Coupled with the acceleration in imports of goods and services, this resulted in a smaller contribution of net exports of goods and services to GDP growth compared with the previous quarter.

In 2006 Q4, latest economic indicators continued to reflect a softening in domestic demand while exports of goods and services expanded well in line with a better-than-expected trading partners' growth. For the year 2006 as a whole, the MPC assessed that the Thai economy would grow by approximately 5.1 percent – marginally higher than the range projected in the previous *Report*.

With regard to economic stability, inflationary pressure clearly subsided, owing partly to a decline in oil prices. Although flooding caused raw food prices to rise quite substantially at the beginning of the quarter, the impact on inflation was only temporary. As a result, average headline and core inflation in 2006 Q4 moderated to 3.3 and 1.7 percent, respectively. For the whole year, headline and core inflation averaged at 4.7 and 2.3 percent, respectively, well within the ranges projected in the previous *Report* of 4.3 – 4.8 and 2 – 2.5 percent, respectively.

The recent decline in oil prices along with a stable interest rate helped support overall economic and financial stability. The corporate and household sectors' balance sheets remained firm, while the strength of financial institutions remained satisfactory, as reflected by a sound performance and credit quality.

Overall external stability was also satisfactory. The current account continued to be in surplus during 2006 H2, as the trade balance improved owing to a remarkable exports performance while imports slowed down in line with domestic demand. Moreover, the net services, income and transfers balance returned to surplus. As a result, the current account recorded a total surplus of 1.2 billion US dollars in 2006 Q3, and an even larger surplus of 2.4 billion US dollars during the first two months of 2006 Q4. The sizable current account surplus was one factor that contributed to the significant appreciation of the baht towards the end of the year. Coupled with high foreign borrowings as well as speculative capital inflows from abroad, it caused the baht to appreciate faster than other regional currencies. As a result, it was necessary for the authority to step up measures concerning capital inflows in order to maintain stability of the real economy.

Economic growth and inflation projections

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

1. The Dubai oil price assumptions were adjusted downwards for the entire projection period, averaging at 56.5 and 56.0 US dollars per barrel in 2007 and 2008, respectively. This adjustment was in line with softening world demand for crude oil and increasing crude oil supply.

2. Assumptions on the direction of world farm prices remained more or less the same as those used in the previous *Report*, although world farm price levels were adjusted downwards slightly towards the end of the projection period in line with the projections of the International Monetary Fund. Meanwhile, assumptions on non-fuel commodity prices were unchanged.

3. The fed funds rate was expected to decline by 25 basis points to stand at 5.00 percent per annum by mid-2007 in order to stimulate the US economy and would remain at that level until the end of the projection period.

4. The growth rate of Thailand's trading partners' economies in 2007 was still expected to slow down from 2006, but was revised up slightly from the previous *Report* due to an upward revision for the Asian economies. As for 2008, it was expected that Thailand trading partners' economies would improve overall.

5. Regional exchange rates remained on a similar appreciation trend as in the previous *Report*.

6. Assumptions on public consumption and investment for fiscal years 2007 and 2008 were more or less in line with those in the previous *Report*.

Risks to the economy going forward included:

(1) Fluctuations in world oil prices owing to uncertainties in the supply of oil despite a marked decline in oil prices during the recent period;

(2) Consumer and investor confidence, which remained fragile as a result of various uncertainties from the events that occurred between the end of December 2006 and the beginning of January 2007; and

(3) A more-than-expected slowdown in the US economy, which would further suppress global demand.

The MPC thus assessed that in 2007 the Thai economy would expand by around 4 – 5 percent with 87.6 percent probability and by around 4 – 5.5 percent with 88.1 percent probability in 2008.

Possible upward pressure on inflation in the future periods could come from an acceleration in world oil prices and upward price adjustments of administered goods and services by the Ministry of Commerce. Meanwhile, a lower-than-expected domestic demand could cause core inflation to be lower than the baseline projection. The MPC thus projected that headline inflation would continue to slow down from last year, averaging around 1.5 – 2.5 percent in 2007 and within a wider projection range of 1 – 2.5 percent for 2008. At the same time, core inflation should average around 1 – 2 percent in both 2007 and 2008.

Monetary policy stance in the last 3 months

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

1. In the Monetary Policy Committee's meeting on 13 December 2006, the MPC viewed that the Thai economy expanded satisfactorily during the first 10 months of 2006, with exports as the main engine of growth. At the same time, overall economic stability improved, in particular core inflation decelerated. Nevertheless, some price pressure remained. The MPC thus decided to maintain the policy rate at 5.00 percent per annum and deemed that the momentum of private investment be closely monitored. Moreover, the MPC decided to change the policy rate from the 14-day repurchase rate to the 1-day repurchase rate, effective from the next MPC meeting. This would further enhance the efficiency of monetary policy implementation as well as facilitate the development of the Thai financial markets.

2. In the Monetary Policy Committee's meeting on 17 January 2007, the MPC viewed that domestic demand continued to slow down both in consumption and investment. Meanwhile, inflationary pressure clearly subsided. Overall, the MPC assessed that the risk to growth outweighed that of price stability and thus decided to lower the policy rate to 4.75 percent per annum in order to support growth going forward.

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For further information: Vararat Khemangkorn Tel. 0 2356 7876 e-mail: Vararatk@bot.or.th