BANK OF THAILAND NEWS
Communications and Relations Office, Management Assistance Department
Tel. 0-2283-5016-7 FAX 0-2281-5648 www.bot.or.th

No. 34 /2007

Inflation Report July 2007

Mrs. Suchada Kirakul, Assistant Governor, Monetary Policy Group, Bank of Thailand (BOT) announced that the Monetary Policy Committee (MPC) released the July 2007 issue of the *Inflation Report* on 27 July 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

In 2007 Q1, the Thai economy expanded by 4.3 percent year-on-year, which was the same rate of growth as in the previous quarter. Nevertheless, private spending continued to weaken, in particular private investment contracted. Meanwhile, exports continued to expand well and served as the main engine of growth for the economy together with accelerating government consumption.

Latest economic indicators in April and May showed an improvement in domestic demand. In particular, the private consumption and private investment indices increased from the previous quarter's averages as a result of improving sentiment due to unwinding political uncertainties, fiscal stimulus, low inflation which helped maintain purchasing power, as well as accommodative monetary policy. Such improvement in domestic demand, coupled with exports which continued to expand well, provided good prospect for the Thai economy going forward.

With regard to economic stability, inflationary pressure continued to decline in 2007 Q2 as a result of raw food prices which decelerated from the previous quarter and retail oil prices which continued to be below those of the same period last year, despite higher world oil prices. Moreover, domestic demand which had yet to fully recover made price adjustments difficult even after the lifting of the 8th statement of the Administrative Reform Council under the Democratic System (ARC) that prohibited increases in prices of all goods and services. As a result, headline and core inflation in 2007 Q2 averaged at 1.9 and 0.8 percent, respectively.

The economic slowdown did not significantly affect the balance sheets of corporates and households. Although corporate profitability declined and household's delinquency rate rose slightly, the monetary policy stance that had started to become more accommodative would help alleviate the financial burden of these sectors. This, coupled with the good performance of financial institutions and a positive sign in the equity market, suggested that stability of the overall economic and financial system was not yet a concern.

External stability as a whole was also satisfactory. The trade balance and current account registered rather high surpluses in 2007 Q1 as exports expanded well and imports slowed down in line with domestic demand. As for 2007 Q2, the trade balance was expected to register a smaller surplus because imports of raw materials continued to expand well in line with exports and imports of capital and consumer goods began to accelerate. Meanwhile, the net services, income and transfers balance was expected to be in deficit due to seasonal factors, namely interest and dividend payments. Overall, the current account was expected to record a small surplus. Such continuation of current account surplus put pressure on the baht to appreciate.

Economic growth and inflation projections

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

1. The Dubai oil price assumptions were adjusted upward for the entire projection period, averaging at 63.8 and 65.0 US dollars per barrel in 2007 and 2008, respectively. This adjustment was in line with demand for oil which continued to be high while supply did not increase by as much as was anticipated together with intensifying political tensions in oil producing countries. Meanwhile, the domestic retail petroleum price index[1] was assumed to average at 292.3 and 290.3 in 2007 and 2008, respectively, up just slightly despite somewhat higher world oil prices due to the stronger baht.

2. Assumptions on the direction of world farm prices were revised upwards while those of non-fuel commodity prices were similar to previous ones, in line with the projections of the International Monetary Fund.

3. The fed funds rate was expected to remain at the current rate of 5.25 percent per annum until the end of the projection period, differing from the previous assumption which anticipated a rate cut. Such revision was due to higher inflationary risks in the US.

4. The growth rate of Thailand’s trading partners’ economies in 2007-2008 was expected to be slightly higher as a result of an upward revision for the Asian economies as well as the euro area, which would help compensate for the slowdown in the US economy.

5. Regional exchange rates were assumed to appreciate by more than the previous assumptions.

6. For fiscal years 2007-2008, the assumption on government consumption was revised upward while that of public investments was revised downward slightly due to a change in the budget structure.

Looking ahead, risks that could cause the economy to expand lower than the baseline projections included higher-than-expected world oil prices owing to uncertainties in the supply of oil that could be influenced by many factors, a stronger-than-expected appreciation in the baht, and lower-than-targeted budget disbursement rates. Meanwhile, risks that could cause the economy to expand higher than the baseline projections included a faster-than-expected recovery in consumer and business sentiments, a stronger-than-expected impact of low interest rates on decisions to consume and invest once uncertainties were resolved, and a less-than-expected slowdown in external demand.

The MPC thus assessed that in 2007 the Thai economy would expand by around 4 – 5 percent with 98.7 percent probability and by around 4.5 – 6 percent with 92.2 percent probability in 2008.

Possible upward pressures on inflation that might cause inflation to be higher than the baseline projections could come from prices of oil and farm produces as well as subsequent upward price adjustments following a recovery in domestic demand given that producers had to bear higher production costs for quite sometime already. Meanwhile, a slower-than-expected

---

[1] 1996 = 100. The index comprises benzene oil, diesel oil, LPG gas, fuel oil and kerosene where the weights are 19.3, 46.8, 8.3, 25.4, and 0.2, respectively.

recovery in domestic demand, an appreciating trend in the baht and price administration measures by the Ministry of Commerce could cause inflation to be lower than the baseline projections.

The MPC thus projected that headline inflation would average around 1.5 – 2.5 percent with 96.9 percent probability in 2007 and around 1 – 2.5 percent with 89.6 percent probability in 2008. At the same time, core inflation should average around 0.8 – 1.5 percent with 99.7 percent probability, slightly lower than the previous projection, and 1 – 2 percent with 85.9 percent probability in 2007 and 2008, respectively.

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 23 May 2007, the MPC viewed that domestic demand continued to soften given fragile sentiments while public spending had yet to fully accelerate. Meanwhile, inflationary risks remained low despite higher world crude oil prices because the pass-through was limited as a result of weak domestic demand. The MPC thus decided to lower the policy rate from 4.00 percent per annum to 3.50 percent per annum in order to facilitate growth while inflationary pressure remained manageable.

2. In the Monetary Policy Committee's meeting on 18 July 2007, the MPC viewed that domestic demand began to show signs of a slight improvement in April and May but fragility remained due to sentiments which were still low. At the same time, inflation in 2007 H1 was lower than expected despite higher world oil prices due partly to a stronger baht and private spending which had yet to fully recover. Thus, the MPC assessed that risks to growth remained, in particular private spending which still required support for a continued recovery, whereas risks to inflation declined. The MPC thus decided to lower the policy rate from 3.50 percent per annum to 3.25 percent per annum.

Bank of Thailand
27 July 2007

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