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. 2/2008

Inflation Report January 2008

Ms. Duangmanee Vongpradhip, Assistant Governor, Monetary Policy Group, Bank of Thailand (BOT) announced that the Monetary Policy Committee (MPC) released the January 2008 issue of the *Inflation Report* on 25 January 2008. 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 Q3, the Thai economy continued to expand from the first two quarters of the year and recorded a 4.9 per cent year-on-year growth rate. This was attributable to improvements in private investment and consumption. Moreover, public spending accelerated and exports continued to grow well. As a result, during the first 3 quarters of 2007, the Thai economy recorded a growth rate of 4.5 per cent year-on-year.

Latest economic indicators in October and November 2007 reflected a continuous recovery in private investment and consumption owing to improvements in business and consumer sentiments following the unwinding of political uncertainties. Moreover, fiscal stimulus remained strong, and exports continued to expand by more than expected. Nevertheless, the recovery remained fragile as a result of remaining concerns over the global economic outlook, higher oil prices and the uncertainty surrounding the formation of the new government - a factor that would have an impact on the continuation of policies.

With regard to economic stability, inflationary pressure began to rise in 2007 Q4 after remaining low during the previous three quarters of the year. Such an increase in inflationary pressure was largely due to higher world oil prices that fed into domestic retail oil prices, which in turn passed through to costs of public transportation. In addition, non-fuel commodity prices also accelerated and resulted in higher costs of production. As a result, prices of consumer goods and services gradually adjusted higher, including those under the authorities' price administration measures. As such, headline and core inflation in 2007 Q4 edged up and stood at 2.9 and 1.1 per cent, respectively.

The balance sheets of commercial banks, corporates and households were not significantly affected by the economic slowdown during the first half of 2007 prior to the recovery in the third quarter. For commercial banks, despite a slight increase in the ratio of non-performing loans to total loans, the ratio of regulatory capital to risk-weighted assets stayed well above international standards and overall profitability remained sound. As for businesses, an improvement in profitability was noted. Turning to households, the ratio of non-performing loans to total household loans remained low overall; however, delinquency rates in the low to middle income group continued to rise from the previous quarter. This would be an area to monitor for some time to ensure that it does not become a problem in the future.

External stability as a whole was sound. The trade balance in 2007 Q3 and the first 2 months of 2007 Q4 continued to register a high surplus. Moreover, the net services, income and transfers balance improved, and overall the current account continued to register a high surplus.

Economic growth and inflation projections

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

1. The Dubai oil price that rose significantly more than expected during 2007 Q4 led to upward revisions in the assumptions for 2008 and 2009. As a result, the Dubai oil price assumptions stood at 85.5 and 86.0 US dollars per barrel in 2008 and 2009, respectively. The assumptions on domestic retail oil prices were also adjusted higher.

2. Assumptions on world farm prices were revised upwards in line with prices of rice and rubber. At the same time, assumptions on non-fuel commodity prices were also revised upwards in line with prices of farm products used in the production of bio-fuel and base metal prices.

3. The fed funds rate was expected to adjust lower in 2008 Q1 due to the problems in the US subprime market, stabilizing at the rate of 3.50 per cent per annum until the end of the projection period.

4. The growth rate of Thailand's trading partners' economies in 2007 was expected to be higher than previously assumed given latest actual data. Nevertheless, trading partners' economies were expected to slow down by more than previously projected in 2008 as a result of the wide spreading problems in the US subprime market, before an expected recovery in 2009.

5. Regional exchange rates were assumed to appreciate by more than the previous assumptions largely as a result of a continued depreciation in the US dollar.

6. The assumption on government consumption in fiscal year 2008 was revised upwards due to a revision in the assumptions regarding the budget structure and a downward adjustment in the assumptions on subsidies and transfers. As such, the assumption on central government's current expenditure became higher. Meanwhile, the assumption on public investments was revised downwards due to upward revisions in the assumptions on capital transfers to local governments and various funds where the disbursement rate was assumed to be lower than that of the central government's.

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 possible deterioration in consumer and business sentiments should political uncertainties return, a lower-than-expected trading partners' economic growth due to larger-than-expected problems in the US subprime market, and a stronger-than-expected appreciation in the baht. Meanwhile, a risk that could cause the economy to expand higher than the baseline projections would be a stronger-than-expected fiscal stimulus. The MPC thus assessed that in 2007 the Thai economy would expand by approximately 4.8 per cent. As for 2008 and 2009, the MPC assessed that growth would be around 4.5-6 per cent with 93.4 and 80.8 per cent probabilities, respectively.

Possible upward price pressures that might cause inflation to be higher than the baseline projections could come from higher-than-expected prices of oil and non-fuel commodities including farm prices, a higher-than-expected pass-through of production costs to consumer prices, increases in cigarette and alcohol excise tax ceilings as well as a possible upward adjustment of the VAT. Meanwhile, a slower-than-expected recovery in domestic demand and an appreciating trend in the baht could cause inflation to be lower than the baseline projections. The MPC thus projected that headline inflation would average around 2.8-4 per cent with 92.3 per cent probability in 2008, up from the previous forecast, and around 1.8-3.3 per cent with 89.1 per cent probability in 2009. At the same time, core inflation should average around 1.3-2.3 per cent with 94.3 per cent probability in 2008, up slightly from the previous forecast, and around 1.5-2.5 per cent with 81.4 per cent probability in 2009.

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 4 December 2007, the MPC viewed that domestic demand started to recover and exports continued to expand well. Meanwhile, inflation began to accelerate in line with rising world oil and commodity prices. In addition, the pass-through from costs to the prices of other goods and services was likely to increase going forward. Overall, the growth momentum improved although risks still remained, particularly from the global economy. The risks to inflation increased, compared to the previous meeting. However, core inflation was expected to remain within the target range for the next 8 quarters. The MPC therefore decided to keep the policy interest rate at 3.25 per cent per annum.

2. In the following Monetary Policy Committee's meeting on 16 January 2008, the MPC viewed that domestic demand showed signs of continued recovery while export growth continued to be robust. At the same time, headline inflation was expected to accelerate for some time due to higher world oil and commodity prices. Core inflation was likely to rise in line with the recovery in domestic demand and the pass-through from higher costs but should remain within the target range throughout the next 8 quarters. The overall growth momentum improved from the previous meeting from domestic demand, but the uncertainty surrounding the risks to growth and inflation became higher and should be monitored closely going forward. The MPC therefore decided to keep the policy interest rate at 3.25 per cent per annum.

Bank of Thailand
25 January 2008
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