



BANK OF THAILAND NEWS

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Inflation Report April 2008

Ms. Duangmanee Vongpradhip, Assistant Governor, Monetary Policy Group, Bank of Thailand (BOT), announced that the Monetary Policy Committee (MPC) released the April 2008 issue of the *Inflation Report* on 22 April 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 Q4, the Thai economy expanded by 5.7 per cent year-on-year, which was higher than the rates recorded in the previous three quarters. This was attributed to the acceleration in net exports and private investment, while private consumption grew at a rate close to the previous quarter. As a result, for the whole year, the Thai economy expanded by 4.8 per cent in 2007.

Latest economic indicators in January and February 2008 reflected a continued recovery in private consumption and investment. Supporting factors included a strong momentum from the latter part of 2007, clarity and continuity of government policies since the formation of the new government, and accommodative monetary policy. Although higher inflation dented consumers' purchasing power somewhat, it was unlikely to the extent that would affect spending, especially the part that had been postponed from the previous quarters. Moreover, public spending remained strong and exports continued to expand by more than expected.

With regard to economic stability, inflationary pressure rose significantly in 2008 Q1, due to higher world oil prices that fed into domestic retail oil prices, as well as to higher fresh food prices owing to agricultural products such as rice, meat, vegetables and fruits, which in turn led to significantly higher prices of processed food and beverages, especially food at and away from home. In addition, the pass-through of higher production costs resulted in the continued upward adjustments in the prices of non-food and non-energy items. Thus, headline inflation accelerated from 2.9 per cent in 2007 Q4 to 5.0 per cent in 2008 Q1, while core inflation edged up from 1.1 per cent to 1.5 per cent.

The ongoing recovery in domestic demand led to improvements in the stability of domestic-oriented firms, as reflected by their rising sales and operating profit margins despite higher costs of production. However, profitability of export-oriented businesses still declined, due to increasing costs as well as the appreciating exchange rate which reduced profits in baht terms. Nevertheless, credit worthiness and liquidity of these businesses as a whole remained satisfactory. Meanwhile, households' balance sheets stayed sound, partly owing to their cautiousness in both spending and debt creation. Overall stability of financial institutions also remained sound. Even though Thai commercial banks recorded a net loss in 2007 Q4, it was due

mainly to the loan loss provisions pursuant to IAS 39. Moreover, the ratio of regulatory capital to risk-weighted assets stayed well above international standards, and the ratio of non-performing loans to total loans declined following the recovery of domestic economic activities.

Overall external stability was sound. The current account remained in surplus in 2007 Q4 and the first two months of 2008, due largely to the continued surplus in the net services, income and transfers account. Meanwhile, the trade balance registered a surplus in 2007 Q4, but recorded a small deficit in the first two months of 2008, due to accelerating imports along with the recovery in domestic demand.

Economic growth and inflation projections

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

1. Dubai oil price assumptions were revised up to average at 93.3 and 94 US dollars per barrel in 2008 and 2009, respectively, in line with the higher-than-expected increase in oil prices in the previous periods. The assumptions on domestic retail oil prices were also adjusted higher accordingly.

2. Assumptions on world farm prices and non-fuel commodity prices were revised upwards in line with the recent acceleration in the prices of farm products, some of which to be used in the production of bio-fuel, and base metal prices.

3. The fed funds rate was expected to soften by more than previously assumed due to the Fed's accommodative monetary policy stance to resolve liquidity problems in the financial system and to stimulate the US economy. As a result, the fed funds rate was expected to decline to 1.50 per cent per annum by end-2008 Q3, and remain at that level until the end of the projection period.

4. The growth rate of Thailand's trading partners' economies was expected to be lower than previously assumed both in 2008 and 2009, due to the repercussions of the US subprime problems to the EU and Japan, both of which maintain close financial and trade linkages with the US. Asian economies were also expected to be affected by the problems in the US.

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

6. The assumption on government consumption and public investment in fiscal year 2008 was the same as previously assumed. However, it was revised upwards for fiscal year 2009 as the higher budget deficit of 2.5 per cent of GDP had been approved by the Cabinet on 18 March 2008.

Looking ahead, major risks that could cause the economy to expand below the baseline projections included higher-than-expected world oil prices, owing to tight oil supply and volatile speculative oil demand in the futures market, and lower-than-expected trading partners' economic growth due to worse-than-expected problems in the US subprime market which could at the same time lead to an even weaker US dollar and thus a more rapid appreciation in regional currencies and the baht. Meanwhile, possible risks that could cause the economy to expand above the baseline projections included the fiscal stimulus package as well as a stronger-than-expected recovery in consumer and investor confidence due to the clarity of government policies, which should in turn enhance the investment climate despite remaining risks from political uncertainties.

Taking these risks into consideration, the MPC assessed that the Thai economy would expand by around 4.8-6 per cent in 2008 and 4.5-6 per cent in 2009, with 93.9 and 82 per cent probabilities, respectively.

Possible upward price pressures that might cause inflation to be higher than the baseline projections included higher-than-expected prices of oil and non-fuel commodities, including farm prices, and a higher-than-expected pass-through of production costs to consumer prices. On the contrary, more stringent price administration by the government could lead to a milder-than-expected pass-through of costs, while the possibility of a stronger baht could also cause inflation to be lower than the baseline projections. Overall, the MPC viewed that headline inflation would be higher than previously projected both in 2008 and 2009, averaging around 4-5 and 2.8-4.3 per cent with 92 and 83.9 per cent probabilities, respectively. At the same time, core inflation was also expected to be higher than previously projected, averaging around 1.5-2.5 per cent in 2008 and 2-3 per cent in 2009, with 99.4 and 84.9 per cent probabilities, respectively.

Monetary policy stance in the last 3 months

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

1. In the Monetary Policy Committee's meeting on 27 February 2008, the MPC judged that the overall growth momentum had improved due to the pickup in domestic demand while exports continued to expand well. Headline inflation adjusted upwards and could continue to accelerate in the near future as a result of higher world oil and commodity prices. Nonetheless, it was expected to moderate going forward, and core inflation was still likely to remain within the target range throughout the next eight quarters. However, risks from the global economy had increased and could affect the Thai economy going forward. 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 9 April 2008, the MPC viewed that the economy continued to have good growth momentum from domestic demand. Exports continued to expand well, but the slowdown in the global economy could affect export growth going forward. At the same time, risks to inflation increased due to the prices of oil and commodities in world markets, as well as a stronger pass-through of costs to domestic consumer prices. Nevertheless, these pressures were likely to moderate in the latter part of the year in tandem with the slowdown of the global economy. With risks to inflation and growth both increasing, the MPC decided to maintain the policy interest rate at 3.25 per cent per annum.

Bank of Thailand

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