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Inflation Report July 2008

Ms. Duangmanee Vongpradhip, Assistant Governor, Monetary Policy Group, Bank of Thailand (BOT), announced that the Monetary Policy Committee (MPC) released the July 2008 issue of the *Inflation Report* on 28 July 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 2008 Q1, the Thai economy expanded by 6 per cent year-on-year, which was higher than the 2007 annual average of 4.8 per cent. This pickup was due to an improvement in domestic demand, especially private expenditure, while external demand continued to expand favourably.

Latest economic indicators in April and May 2008 reflected slight moderation in consumption and investment growth, which could be attributed to deteriorating consumer and business confidence and heightened political uncertainty. Even if somewhat weaker than expected, domestic demand continued to grow well from public spending, which was close to target, government tax measures as well as cumulative impact of accommodative monetary policy. Exports continued to expand by more than expected since the global economy did not slow down by as much as the MPC previously projected.

With regard to economic stability, inflationary pressure rose significantly in 2008 Q2, due to higher domestic retail oil prices on the back of continued increases in world oil prices, together with an acceleration in fresh food prices following the prices of agricultural products. Moreover, concurrent increases in various types of production costs made for a relatively higher speed of the pass-through from costs to prices of goods and services. Thus, both headline and core inflation increased from 5.0 per cent and 1.5 per cent respectively in 2008 Q1 to 7.5 per cent and 2.8 per cent respectively in 2008 Q2.

Overall external stability remained sound. Despite declining trade and current account surplus, owing mainly to higher import prices, international reserves position and external liquidity indicators remained satisfactory.

Meanwhile, the ongoing recovery in domestic demand coupled with continued external demand expansion helped improve corporate sector profitability. The household sector's debt service ability remained satisfactory as households remained cautious with borrowing and spending. An improvement in the financial conditions of the corporate sector as well as households' financial discipline contributed to satisfactory debt quality and sound overall stability of financial institutions.

Economic growth and inflation projections

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

1. The assumption on Dubai oil price was revised upwards to average at 119.6 and 135.0 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. The assumption on world farm prices was revised upwards, in line with the acceleration in rice prices during the second quarter of 2008. The assumption on non-fuel commodity prices was also revised upwards due to higher-than-expected prices of farm products, especially those which were to be used in the production of bio-fuel, as well as rising transportation cost and prices of fertilizer.

3. The fed funds rate was higher than previously assumed following the Fed's heightened concern about inflation in the recent months.

4. The growth rate of Thailand's trading partners' economies was expected to be higher than previously assumed both in 2008 and 2009, due to less-than-expected slowdown in the major economies during the first quarter of 2008 and continued robust expansion in Asian economies, which provided reasonably good momentum to Thailand's trading partners' economies going forward.

5. Regional currencies were assumed to appreciate vis-à-vis the US dollar by less than the previous assumptions as a result of a continued appreciation in the US dollar and the monetary policy stance of the US Federal Reserve, which was assumed to be tighter.

6. The assumption on government consumption and public investment in fiscal year 2008 was the same as the previous one. However, it was revised upwards for fiscal year 2009 in line with a higher-than-expected proportion of government consumption in the newly approved budget.

The MPC viewed the forecast assumptions stated above as most likely. However, there are risks that could cause the economy to expand below or above the baseline projection. Important negative risk factors included higher-than-expected world oil prices owing to uncertainty in the oil supply; lower-than-expected trading partners' economic growth due to fragile growth in the US economy; potentially sizeable losses incurred by European financial institutions following problems in the US subprime market; and the possibility of tightening monetary policy by a number of Asian central banks facing accelerating inflation. Meanwhile, important positive risk factors included the possibility that the government would expedite budget disbursement and approve supplementary budget to counter the adverse effects of high-than-expected inflation, as well as lower-than-expected world oil prices. On the whole, the MPC viewed that negative risks outweighed positive risks, with the projection of economic growth for 2008 and 2009 in the ranges of 4.8-5.8 per cent and 4.3-5.8 per cent with probability of 84.2 and 79.7 per cent, respectively. These forecast ranges are somewhat lower than the previous ones as domestic demand was expected to take longer to recover compared to the previous projection.

Going forward, although inflationary pressures could be lessened somewhat in the short term by the government's measures aimed at reducing costs of living, there remained important risk factors that could cause inflation to be higher than the baseline projection. These risks were as follows. First, world oil prices could be higher than the baseline assumption. Second, the pass-through of costs of production to prices of goods and services could increase, partly as a result of rising inflation expectations. However, lower-than-expected world oil prices could cause inflation to be lower than the baseline projection. On the whole, the MPC viewed that headline inflation would be higher than the previous projection for 2008 and 2009, averaging in the ranges of 7.5-8.8 and 5.0-7.5 per cent with probability of 78.5 and 74.7 per cent, respectively. Core inflation would also be higher and was expected to be in the range of 2.8-3.8 per cent in 2008 and remain elevated in the range of 3.0-4.0 per cent in 2009, with probability of 97.9 and 70.6 per cent, respectively. Nevertheless, appropriate monetary policy would help contain inflation expectations and facilitate a faster return of core inflation to within the target range of 0-3.5 per cent.

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 meeting on 21 May 2008, the MPC assessed that Thai economy continued to expand, but rising costs of production and higher inflation could dampen private sector's confidence and spending going forward. Headline inflation accelerated as a result of the significant increase in energy and raw food prices as well as higher cost-to-price pass-through. As a result, the risks to economic growth and inflation had both risen. The MPC therefore decided to keep the policy interest rate at 3.25 per cent per annum for the time being. Should inflation continue to accelerate, the MPC would stand ready to adjust the monetary policy stance accordingly.

2. In the following meeting on 16 July 2008, the MPC viewed that the Thai economy continued to expand, but there were indications that the acceleration in inflation had begun to affect business confidence, private consumption and investment spending, as well as price competitiveness of the export sector. Risks to inflation increased markedly due to the rapid acceleration in pass-through from producer prices to the prices of other goods, which was facilitated by continued economic expansion. Indicators of inflation expectations have increased, which would affect private sector confidence, make it increasingly difficult to ensure economic stability going forward, and impact potential growth as well as the competitiveness of the Thai economy in the long run. The MPC therefore decided to raise the policy interest rate by 0.25 per cent, from 3.25 per cent to 3.5 per cent per annum, and would stand ready to adjust the monetary policy stance should inflationary risks continue to remain elevated.

Bank of Thailand
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