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Inflation Report October 2008

Ms. Duangmanee Vongpradhip, Assistant Governor, Monetary Policy Group, Bank of Thailand (BOT), announced that the Monetary Policy Committee (MPC) released the October 2008 issue of the *Inflation Report* on 17 October 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 Q2, the Thai economy expanded by 5.3 per cent year-on-year, which was softer than the growth rate of 6.1 percent in the first quarter of the year and lower than what the MPC had expected. The softer growth momentum was due in part to a slowdown in private expenditure, following the deterioration in consumer and business confidence consequent of substantial increases in the costs of living and production. In addition, public expenditure contracted in real terms as actual budget disbursement was lower than expected. Nonetheless, exports expanded well and contributed as a key driving force behind the overall economic expansion.

In 2008 Q3, domestic demand showed signs of a continued slowdown. Various factors, which were unfavourable to the expansion of domestic demand, accentuated including deteriorating business and consumer confidence, heightened political uncertainty and sluggish government spending. Subsiding inflationary pressure was the only supportive factor to domestic demand growth. Meanwhile, the trend in the global economy worsened as a consequence of the US financial crisis, causing some deceleration in Thai exports. The global economic slowdown coupled with political uncertainty, which took a toll on foreign tourists' confidence, also led to a contraction in exports of services, tourism in particular, and thus further dampened the overall growth momentum.

While risks to economic growth were elevated, risks to inflation clearly moderated. The moderation was due to lower world oil and agricultural prices as the global economy slowed down. Moreover, temporary government measures to ease consumers' living costs relieved some concerns over inflation and thereby reduced pressure on wage adjustments. This was in line with the continued moderation in inflation expectations from August 2008 onwards. Nonetheless, some inflationary pressure remained as there was still evidence of a gradual pass-through of production costs, which had gone up significantly in the earlier periods, to retail prices such as the prices of processed food at and away from home. There was also pent-up pressure from administered prices under the Ministry of Commerce's price administration measures.

Economic stability on the other fronts remained satisfactory. Although the current account was in deficit in the first two months of 2008 Q3, it was consistent with what the MPC had anticipated. Meanwhile, international reserves position and external liquidity indicators stayed sound. In the first half of this year, corporate sector profitability and the ability of households to service debt were satisfactory. At the same time, non-performing loans (NPLs) declined. This suggested that the household, business and financial sectors were sound enough to withstand some elevation of risk factors posed by the economic slowdown and volatile global financial system going forward.

Economic growth and inflation projections

In forming economic and inflation forecasts for the next eight quarters, the MPC carefully reviewed the assumptions used in the forecasting process. Compared to the assumptions used in the projections three months earlier, the latest assumptions can be summarized as follows.

1. The assumptions on Dubai oil price for the rest of 2008 and the whole of 2009 were revised downwards, following a declining trend of oil prices that was in line with a slowdown in the global economy. As a result, the Dubai oil price was assumed to average at 104.1 and 95.0 US dollars per barrel in 2008 and 2009, respectively.
2. The assumption on agricultural prices was revised downwards, consistent with the slowdown in global demand and easing supply constraints for some agricultural products such as rice. The assumption on non-fuel commodity prices in 2008 was close to that previously assumed but was lowered in 2009 in line with the global economic slowdown.
3. The growth rate of trading partners' economies was revised downwards both in 2008 and in 2009 to reflect a larger impact of the US financial crisis than previously assessed.
4. The fed funds rate was lower than that previously assumed following the more urgent need to resolve the escalating economic problem in the US.
5. Regional currencies were assumed to depreciate vis-à-vis the US dollar due to capital outflows from regional economies back to the US to relieve the severe liquidity problem in the US financial market as well as to reduce exposures to risky assets (risk aversion) as uncertainty in global economic and financial conditions mounted.
6. Public spending was lower than that previously assumed. In fiscal year 2008, this was a consequence of lower disbursement rate as had already been reflected in the actual data. As for fiscal year 2009, it was due to a higher assumption on government transfers, which would not be counted as public spending, and a downward revision on investment spending by state-owned enterprises due to uncertainty in several investment projects.

The MPC viewed the forecast assumptions stated above as most likely. In the case of baseline projections based on such assumptions, economic growth was expected to be lower than the MPC's previous projection both in 2008 and 2009, due to the softer-than-expected growth momentum from the first half of 2008 and weaker global economic prospect. Meanwhile, inflation was expected to be lower than previously anticipated as a result of the decline in oil prices following a slowdown in the global economy, the psychological impact of the government's measures to ease consumers' living costs, and a delayed recovery in domestic demand which would dampen demand pressure on inflation going forward.

However, the MPC viewed that there were risk factors that could cause the economy to expand below or above the baseline projections. On the whole, the MPC viewed that negative risks outweighed positive risks. Particularly, it was possible that trading partners' economies would sharply slow down, budget disbursement could fall below the rate expected under the baseline scenario, and political uncertainty could affect business and tourists' confidence by more than anticipated. Therefore, the fan chart for economic growth was skewed downwards, with the projection of economic growth in the range of 4.3 – 5.0 per cent in 2008 and 3.8 – 5.0 per cent in

2009, with probability of 89 and 76 per cent, respectively. The forecast range already took into account the possibility of the worst case scenario whereby the global economy would fall into a deep recession.

As for inflation projections, downside risks outweighed upside risks at the beginning of the forecasting period as the global economy could fall into a recession, which could then lead to lower-than-expected oil and commodity prices. As the global economy recovered, however, upside risks to inflation would increase. Therefore, the fan chart for headline inflation was skewed downwards at the beginning of the forecasting period but was skewed slightly upwards towards the end. The MPC viewed that the fan chart for core inflation would skew downwards at the beginning similar to that of headline, before becoming balanced towards the end of the forecasting period. On the whole, the MPC projected headline inflation to average within the range of 6.0 – 6.5 per cent in 2008 and 3.0 – 4.0 per cent in 2009, with probability of 87 and 58 per cent, respectively. Meanwhile, core inflation was expected to average within the range of 2.0 – 2.5 per cent in 2008 and 2.0 – 3.0 per cent in 2009, with probability of 96 and 90 per cent, respectively.

Monetary policy stance in the last 3 months

From the assessment of economic conditions and outlook above, the MPC viewed that at the beginning of 2008 Q3, risks to inflation were high, taking a toll on private sector's confidence and demand. Such risks also diminished the degree of price competitiveness of the export sector and could have an impact on the economy's growth potential in the long term. Monetary policy, therefore, needed to be tightened to take care of economic stability. The MPC thus decided to raise the policy interest rate by 0.25 per cent, from 3.25 per cent to 3.5 per cent per annum in the meeting on 27 August 2008.

Towards the end of 2008 Q3, however, financial crisis abroad caused the balance of risks to shift significantly. Risks to growth substantially increased due to an expected slowdown in the global economy as well as impact from domestic political uncertainty. At the same time, risks to inflation subsided following world oil prices and inflation expectations which started to moderate as the global economy and domestic economy slowed down. The MPC therefore decided to maintain the policy interest rate at 3.75 per cent per annum in the meeting on 8 October 2008. However, the MPC would closely monitor the risks to world economy and stand ready to implement appropriate monetary policy should the impact on the Thai economy worsen from the current assessment.

Bank of Thailand
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