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## **Inflation Report January 2009**

Ms. Duangmanee Vongpradhip, Assistant Governor, Monetary Policy Group, Bank of Thailand (BOT), announced that the Monetary Policy Committee (MPC) released the January 2009 issue of the *Inflation Report* on 23 January 2009. 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 Q3, the Thai economy expanded by 4.0 per cent year-on-year, slowing down from the growth rates of 6.0 and 5.3 per cent in the first and second quarters of 2008 respectively, consistent with the MPC's expectation. The softer growth momentum was due to a significant deceleration in net exports, consequent of surging import volume, while private domestic demand started to show clear signs of weakness and government expenditure contracted from the same period of the previous year.

In 2008 Q4, the pace of GDP growth evidently weakened as various adverse factors, both domestic and global, intensified. The marked slip in global growth caused Thai exports to shrink in this quarter, both in value and volume terms. Meanwhile, the shutdown of international airports, following heightened domestic political tension, directly affected the tourism sector and worsened the already soft private sector confidence. Taking into consideration positive contribution from sharp decline in oil prices, which helped ease pressure on the cost of production, the MPC assessed that the economy would expand at around 3.6 per cent in 2008.

Inflationary pressure had clearly subsided as world oil prices declined sharply. Moreover, the downturn in economic activities lowered the ability of producers to pass costs on to consumers. Government measures to ease consumers' cost of living also helped relieve inflation concern and in turn alleviate pressure on nominal wages to rise. This development was consistent with the observed decline in inflation expectations.

External stability remained sound as the current account deficit, though extended into the first two months of 2008 Q4 from the previous quarter, remained low compared to international reserves position. However, corporate sector profitability and the ability of households to service debt deteriorated. In addition, the quality of loans made by financial institutions worsened somewhat, consistent with the softened prospects for the economy, and would require close monitor 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 growth rate of trading partners' economies was revised substantially downwards both in 2009 and 2010 to reflect the impact of the US financial crisis, which led to economic recession in major industrial countries (G3) and a gradual recovery in 2010.

2. The fed funds rate was lower than previously assumed, consistent with the downgraded US economic prospects.
3. Regional currencies were assumed to depreciate against the US dollar in 2009, consequent of the return of capital to the US from regional economies due to risk aversion, and continued to remain at depreciated levels in 2010.
4. Public spending was higher than previously assumed in fiscal year 2009, given the supplementary budget of 115 billion baht, and was slightly lower in fiscal year 2010.
5. The assumption on Dubai oil price for the whole projection period was revised downwards, in line with a declining oil price trend, to average at 45.0 US dollars per barrel in 2009 and 50.0 US dollars per barrel in 2010, consistent with the gradual recovery in global growth.
6. The assumption on agricultural prices was revised upwards in 2009, consistent with latest data, and would taper off in 2010. The assumption on non-fuel commodity prices in 2009 was lower than previously assumed before turning slightly higher in 2010 in line with global economic recovery projection.

The MPC viewed the forecast assumptions stated above as most likely. In the baseline projections, economic growth in 2009 was expected to be considerably lower than the MPC's previous projection, mainly on account of a sharp slowdown in trading partners' economies. The growth momentum would nevertheless be cushioned by more accommodative monetary and fiscal policies coupled with a rapid decline in the costs of production, and the Thai economy would begin to recover gradually in line with the world economy in 2010. Meanwhile, inflation was expected to be lower than the previous projection on account of a drastic fall in oil prices, a slower cost-to-price pass-through as domestic demand softened and the 6-month extension of most of previous government measures to ease consumers' living costs.

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. In particular, the world economy could be in a more prolonged recessionary period than the baseline assumption would suggest; also there was a possibility that the government might not be able to disburse the budget to stimulate the economy as effectively as planned. Therefore, the fan chart for economic growth was skewed downwards for the entire forecasting horizon, with the projection of economic growth in the range of 0.0 – 2.0 per cent in 2009 and 2.0 – 4.0 per cent in 2010, with probability of 84 and 76 per cent, respectively. The forecast ranges already took into account the possibility of the worse-case scenario in which the global economy would fall into a deep recession.

As for headline inflation projections, the MPC viewed that upside risks outweighed downside risks due to an upward skewness in crude oil futures prices. Meanwhile, core inflation was subjected to more downside risks from weaker global and domestic economic conditions as well as the uncertainty at the time of projection surrounding the details of additional government measures to alleviate the costs of schooling announced earlier. Therefore, for the entire forecasting period, the fan chart for headline inflation would skew upwards while the fan chart for core inflation would skew downwards; the latter being in line with the fan chart for economic growth. On the whole, the MPC projected headline inflation to average within the range of -1.5 – 0.5 per cent in 2009 and 1.5 – 3.5 per cent in 2010, with probability of 90 and 82 per cent, respectively. Meanwhile, core inflation was expected to average within the range of 0.5 – 1.5 per cent in 2009 and 1.0 – 2.0 per cent in 2010, with probability of 96 and 85 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 Q4, the economy clearly slowed down while both domestic and external downside risks to growth heightened. The fiscal stimulus was likely to be delayed. Risks to inflation considerably subsided from a substantial decline in oil and commodity prices. Consequently, monetary policy could be eased to help support economic recovery. The MPC therefore decided to lower the policy interest rate by 1.00 per cent per annum, from 3.75 to 2.75 per cent per annum in the meeting on 3 December 2008.

Towards the end of 2008 Q4, the global financial crisis resulted in a significant slowdown of growth in industrial economies, which led to a contraction in Thai exports, while domestic demand continued to soften. However, increasing stability in the domestic political situation should help enable the government to implement its economic stimulus measures going forward. At the same time, risk to inflation had moderated. The MPC thus viewed that monetary policy could be eased further to support the economic recovery and decided to lower the policy interest rate by 0.75 per cent per annum, from 2.75 to 2.00 per cent per annum at the 14 January 2009 meeting.

Bank of Thailand  
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