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Inflation Report April 2009

Ms. Duangmanee Vongpradhip, Assistant Governor, Monetary Policy Group, Bank of Thailand (BOT), announced that the Monetary Policy Committee (MPC) released the April 2009 issue of the *Inflation Report* on 22 April 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 Q4, the Thai economy contracted by 4.3 per cent year-on-year, following the expansion in the preceding three quarters of 2008. The degree of contraction was greater than the MPC had expected due to sharp contraction in net exports as well as a large decline in public and private investment. Consequently, public and private consumption were the major growth drivers in this quarter.

In 2009 Q1, the global economic slowdown took a significant toll on the Thai economy, leading to ongoing contraction in Thai exports, both in terms of volume and value. Had the value of gold exports, the size of which was unprecedented, in the first two months of this quarter been excluded, both the volume and value of exports would contract more substantially. Meanwhile, farm income deteriorated in tandem with declining agricultural prices. Moreover, a substantial increase in excess capacity together with more cautious bank lending worsened the prospects of private sector's investment and durable consumption. Imports of goods and services also contracted markedly following a sharp decline in exports and softer domestic demand. Consistent with other demand components, raw material and gold inventories was run down, while manufacturing and agricultural product inventories continued to accumulate. On the other hand, the drastic fall of oil and commodity prices, consequent of the world economic slowdown, drove the costs of production and overall consumer prices down, which helped cushion consumers' purchasing power to some extent.

Although domestic retail oil prices rose due to the hike in the excise tax rate, inflationary pressure clearly subsided as the slowdown in economic activities lowered the ability of producers to pass the costs of production on to consumers. In addition, government measures to ease consumers' cost of living also helped relieve concerns over inflation and alleviate upward pressure on nominal wage adjustments. This development was consistent with the observed decline in inflation expectations.

External stability remained sound as the international reserves position continued to be high. In addition, the current account in the first two months of 2009 Q1 turned into surplus on the back of deficit during the previous two quarters. However, corporate sector profitability deteriorated considerably, and the ability of households to service debt as well as the quality of loans made by financial institutions worsened somewhat, consistent with the softened prospects for the economy. These issues 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 assumed to be unchanged from the previous projection.
3. Regional currencies were assumed to depreciate further against the US dollar in 2009 and 2010, consequent of the flight to safety of capital to the US from regional economies and weaker regional economic outlook.
4. The level of nominal (direct) public spending was lower than previously assumed in fiscal years 2009 and 2010, as a greater portion of the 97.6-billion-baht supplementary budget constituted transfers to households. Additional spending from the second economic stimulus package, however, would help cushion the decline in the overall public spending in fiscal year 2010.
5. The assumption on Dubai oil price was maintained throughout the projection period, averaging at 44.7 US dollars per barrel in 2009 and 48.8 US dollars per barrel in 2010, in tandem with the global economic recovery.
6. The assumption on agricultural prices was revised slightly downwards in 2009 to reflect latest data before rising in 2010 consequent of the rice, fruit and vegetable price assumptions and the low base. Meanwhile, the assumption on non-fuel commodity prices in 2009 was lower than previously assumed and would rise to a comparable level as previously assumed 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 contraction in exports would lead to softer private investment and consumption. Consequently, imports would contract sharply, resulting in positive net exports. The growth momentum would nevertheless be cushioned by more accommodative monetary and fiscal policies coupled with a rapid decline in the costs of production. Moreover, the MPC assessed that there would be a continuous run down of inventory in 2009. As for 2010, the Thai economy would begin to recover gradually in line with the world economy. The acceleration of imports, in accordance with export and domestic demand expansion, would lead to the contraction of net exports while production units would start accumulating inventories again. At the same time, inflation was expected to be low in 2009 although domestic retail oil prices rose from higher excise tax rate, as soften domestic demand would allow for a slower cost-to-price pass-through. Moreover, government measures to subsidize educational expenses and the extension of measures to ease consumers' living costs until the end of July 2009 should help suppress the inflationary pressure. Inflation would rise at a moderate pace in tandem with the pick-up in economic growth in 2010.

The MPC viewed that there were risk factors that could cause the economy to deviate from the baseline projections. On the whole, the MPC assessed that negative risks to economic growth outweighed positive risks. In particular, the world economy could be in a more prolonged recessionary period than the baseline assumption would suggest and recovery prospects could be delayed. In addition, the lingering political turmoil might lead to government instability, which could manifest itself in the inability of the government to disburse the budget to stimulate the economy as effectively as planned. The political turbulence could have more adverse effect than anticipated on the confidence of investors, consumers and tourists. Therefore, the fan chart for economic growth was skewed downwards for the entire forecasting horizon, and more skewed than the January 2009 fan chart, giving the projection of economic growth in the ranges of (-3.5)-(-1.5) per cent in 2009 and 1.5-3.5 per cent in 2010, with probability of 82.9 and 73.2 per cent, respectively.

As for headline inflation projections, the MPC viewed that the risks were roughly balanced in tandem with the probability attached to oil prices' adjustments. Therefore, for the entire forecasting period, the fan chart for headline inflation was balanced. Meanwhile, core inflation was subjected to more downside risks from weaker global and domestic economic conditions. As a result, the fan chart for core inflation was skewed downwards, consistent with the fan chart for economic growth. On the whole, the MPC projected headline inflation to average within the ranges of -1.0 – 1.0 per cent in 2009 and 1.0 – 3.0 per cent in 2010, with probability of 95.7 and 81.6 per cent, respectively. Meanwhile, core inflation was expected to be within the ranges of 0.0 – 1.0 per cent in 2009 and 0.0 – 1.5 per cent in 2010, with probability of 98.7 and 97.5 per cent, respectively.

Monetary policy stance in the last 3 months

From the assessment of economic conditions and outlook above, the MPC viewed that the global financial crisis had resulted in a significant slowdown of growth in industrial and regional economies, which led to continued contraction in Thai exports. Meanwhile, domestic demand continued to soften. Nevertheless, public spending through fiscal stimulus measures would help compensate for the softening private demand to some extent. At the same time, risks to inflation had moderated. The MPC thus viewed that monetary policy could be eased further to support economic recovery going forward and decided to lower the policy interest rate by 0.50 per cent per annum, from 2.00 to 1.50 per cent per annum at the 25 February 2009 meeting and cut rate further by 0.25 per cent per annum to 1.25 per cent per annum at the 8 April 2009 meeting.

Bank of Thailand
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