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Inflation Report July 2009

Ms. Atchana Waiquamdee, Deputy Governor, Monetary Stability, Bank of Thailand (BOT), announced that the Monetary Policy Committee (MPC) released the July 2009 issue of the *Inflation Report* on 24 July 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 2009 Q1, the Thai economy contracted by 7.1 per cent year-on-year, following a retrenchment in the previous quarter. The decline was sharper than the MPC had expected. Every expenditure component of GDP dropped substantially with significant rundown in inventories. Meanwhile, the current account was in large surplus as imports decelerated faster than exports in tandem with domestic demand contraction.

In 2009 Q2, the overall economy continued to contract on a year-on-year basis, but started to show signs of stabilization with positive quarter-on-quarter growth. On the supply side, manufacturing production rose to make up for earlier slide in inventories and in response to new orders from abroad. On the other hand, farm production and income deteriorated in line with declining agricultural prices as global demand remained subdued. On the demand side, public spending edged up and would be important in shoring up overall growth while private consumption started to stabilize. Private investment, however, contracted slightly from the previous quarter as demand for new investment remained weak, given high current excess production capacity. In addition, the impact from fiscal stimulus as well as improvement in exports pushed imports up slightly from the previous quarter, significantly eroding the current account surplus.

Price pressure continued to decline as a result of negative year-on-year oil price growth, continued government's cost-of-living reduction measures and additional effect from fully subsidized basic education program (effective May 2009). These factors caused the quarterly average core inflation to fall to -0.1 per cent in 2009 Q2, breaching the target range of 0-3.5 per cent per annum set by the MPC. Nevertheless, current negative headline and core inflation rates did not indicate a deflationary period for the Thai economy because, taking away the effect government measures had on consumer price inflation measurement, prices continued to rise moderately and 12-month-ahead public inflation expectation remained above zero.

External stability remained sound as international reserves relative to short-term external debt continued to rise. As for financial stability, the most up-to-date data (2009 Q1) indicated slight improvement in firms' profitability and ability to service debt despite falling sales volume, largely because of reduction in costs. Meanwhile, households' ability to service debt deteriorated from weakened income and employment condition. In addition, financial institutions assessed that credit risk had heightened as loan quality deteriorated during the economic downturn, requiring close monitoring going forward.

<u>Economic growth and inflation projections</u>

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 slightly downward in 2009. In 2010, trading partners' economies would recover at a faster pace than previously assumed.
2. The Fed funds rate was assumed to be unchanged until 2010 Q4 when it was revised upward slightly.
3. Regional currencies would appreciate against the US dollar throughout the projection periods (strengthening compared to previous assumption), as capital flows to the region and emerging market countries increased.
4. Public spending was revised downward in fiscal year 2009 following the reduction in current expenditure and revised slightly upward in fiscal year 2010 in line with the second fiscal stimulus package.
5. The Dubai oil price assumption was revised upward throughout the projection period, averaging at 60.3 US dollars per barrel in 2009 and gradually rising to average at 75.0 US dollars per barrel in 2010, in tandem with trading partners' growth assumption.
6. The assumption on agricultural prices was revised markedly downward in 2009 to reflect latest data on prices of fruit and vegetable in 2009 Q2, and revised slightly downward in 2010.

In the baseline projection, predicated on the above assumptions, GDP growth for 2009 would be significantly lower than the MPC's previous projection. The fall in projected GDP growth was entirely due to a larger-than-expected contraction in 2009 Q1. Indeed, from 2009 Q2 to 2009 Q4, the economy was now projected to grow at a slightly faster pace than the previous projection on a seasonally adjusted quarter-on-quarter basis; and, with high probability, had already bottomed out. Underlying the growth momentum would be fiscal stimulus, accommodative monetary policy and a gradual revival in demand for goods and services from the global economic recovery. The pickup in GDP growth would be steady but measured and carry into 2010. By that time, net exports would begin to contract, as imports accelerated in accord with improvement in exports and domestic demand. Inventory accumulation would return to normal. With regard to inflation, the Cabinet resolution on 14 July 2009 to extend measures to alleviate the costs of living for 5 additional months would continue to suppress inflation in 2009. Inflation would edge up and become higher than previously projected in 2010 after the government lifted those measures at the end of 2009. Oil price increase following global economic recovery would also contribute to higher projected inflation in 2010.

The MPC considered the 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 throughout the projection horizon. In particular, (1) Global growth recovery prospects could be delayed; (2) Domestic political instability could manifest itself in the inability of the government to disburse the budget to stimulate the economy as effectively as planned; (3) The recent global swine flu outbreak could have adverse effect on tourism and private consumption; and (4) Higher oil prices beyond the baseline level would erode business profits and consumer's purchasing power while reducing the real stimulus from government spending through price inflation. The MPC assessed that the likelihood of a delay in global economic recovery would be smaller than in the previous projection. Therefore, the fan chart for economic growth would skew downward to reflect dominating negative risk factors for the entire forecasting horizon, but it would be less skewed than the April 2009 fan chart. The fan chart was as wide as the April 2009 fan chart to reflect the same level of uncertainty, giving the projection of economic growth in the ranges of (-4.5)-(-3.0) per cent in 2009 and 3.0-5.0 per cent in 2010, with probability of 85.2 and 75.6 per cent, respectively.

As for headline inflation projection, the MPC viewed that the risks were roughly balanced in tandem with the probability attached to oil price's risk scenarios. Therefore, for the entire forecasting period, the fan chart for headline inflation was balanced. Meanwhile, core inflation was subject to more downside risks from global and domestic economic conditions. As a result, the fan chart for core inflation would skew downward, consistent with the fan chart for economic growth. On the whole, the MPC projected headline inflation to average within the ranges of (-1.5)-0.0 per cent in 2009 and 3.5-5.5 per cent in 2010, with probability of 97.3 and 84.0 per cent, respectively. Meanwhile, core inflation was expected to be within the ranges of (-0.5)-0.5 per cent in 2009 and 1.0-2.5 per cent in 2010, with probability of 99.2 and 98.1 per cent, respectively.

<u>Monetary policy stance in the last 3 months</u>

From the assessment of economic conditions and outlook above, the MPC viewed that the global financial crisis continued to exert downward pressure on major and regional economies. Nevertheless, the global economy and international financial conditions had gradually improved, though some fragility remained. Accommodative monetary policy stance and fiscal stimulus packages in many countries would help foster an expansion of the global economy in the period ahead. The MPC assessed that the growth of the Thai economy would improve going forward provided that the global economic recovery sustained and the fiscal impetus started to intensify. Current monetary policy remained accommodative and would be supportive of an economic recovery in a subdued inflation environment. The MPC therefore decided to maintain the policy interest rate at 1.25 per cent per annum at the 20 May 2009 and 15 July 2009 meetings and would stand ready to implement appropriate monetary policy to ensure an orderly economic recovery.

Bank of Thailand
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