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Inflation Report October 2009

Mr. Paiboon Kittisrikangwan, Assistant Governor, Bank of Thailand (BOT), announced that the Monetary Policy Committee (MPC) released the October 2009 issue of the *Inflation Report* on 29 October 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 Q2, the Thai economy expanded from the previous quarter on the back of public consumption and investment. Despite a contraction of 4.9 per cent year-on-year, the quarter-on-quarter expansion indicated that the economy had very likely bottomed out. Private consumption and private investment expanded more than the MPC had expected. The current account was still in large surplus as imports contracted more than exports in tandem with weak domestic demand.

Economic indicators in 2009 Q3 revealed that the overall economy continued to expand on a quarter-on-quarter basis at roughly the same rate as it did the previous quarter, but would still contract on a year-on-year basis. Manufacture production (seasonally adjusted) continued to expand from the previous quarter. Farm income contracted at a slower pace, mainly due to higher production. On the expenditure side, private consumption and private investment continued to expand from the previous quarter, as did business and consumer confidence. Meanwhile, public spending edged up as disbursement rate accelerated. Meanwhile, imports rose from the previous quarter on the back of improving domestic demand. Exports also improved in tandem with higher trading partner's demand and tourism revenue, which in turn significantly raise the current account surplus in July and August.

Price pressure continued to decline in 2009 Q3 from the previous quarter. Headline and core inflation were still negative as the MPC had expected. Core inflation contracted slightly quarter-on-quarter from higher base during the third quarter last year. Headline inflation remained in the negative territory, in line with core inflation and negative year-on-year crude oil price inflation. Headline inflation had most likely bottomed out as oil prices continued to rise and the impact from the government's cost-of-living reduction measures had started to taper off.

External stability remained sound. International reserves continued to rise relative to short-term external debt. As for financial stability, the most up-to-date data (2009 Q2) indicated an improvement of firm's profitability and ability to service debt with increased sales volume, in tandem with rising exports and domestic demands. Meanwhile, employment growth prospects improved from higher production and labour demand in the private sector. Overall, financial institutions remained sound as credit risks declined from higher loan quality following improved economic condition.

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 slightly upward throughout the projection period to reflect latest data in 2009 Q2 and Q3 and stronger global economic recovery.
2. The Fed funds rate was assumed to be unchanged in 2009 and revised upward slightly to 0.5 percent within the year 2010 in tandem with the economic recovery in the US.
3. Regional currencies would appreciate against the US dollar throughout the projection periods (strengthened compared to previous assumption) as a result of more buoyant investors' sentiment on emerging markets' growth prospects and capital flows into the region.
4. Public spending was revised downward in fiscal year 2010 and 2011 as the assumed disbursement rate was lowered to be more in line with actual rate in fiscal year 2009, and reduction in public investment, which was shifted toward household transfers instead.
5. The Dubai oil price assumption was revised upward throughout the projection period, averaging at 61.5 and 80.0 US dollars per barrel in 2009 and 2010, respectively, in line with the global economic recovery.
6. The assumption on agricultural prices was revised markedly downward throughout the projection period following a decrease in prices of meat, fruits and vegetables.

In the baseline projection, predicated on the above assumptions, GDP growth for 2009 and 2010 would be higher than the MPC's previous projection mainly from the recovery of the global economy. The pickup in the projected GDP growth in 2009 was due to exports, which accelerated in the second half of 2009. Exports was projected to expand at a brisker pace than imports, resulting in lower inventory accumulation. Private domestic demand would significantly improve while public spending rose, as in the previous projection. From 2010 onwards, domestic demand, especially from the private sector would be able to replace public spending as a growth driver. In the meantime, imports and exports would continue to grow with imports rising faster than exports. Furthermore, inventory accumulation would contribute significantly to aggregate expenditure growth in 2010, as inventory was significantly depleted in 2009.

With regard to inflation in 2009, the extension of government's measures to alleviate the costs of living and low oil prices would continue to suppress inflation. Inflation would then edge up and become higher in 2010 after the government lifts those measures at end-2009, and on the back of oil price increase following the global economic recovery. The MPC projected that core inflation would return to within the policy target range in 2010 Q1 while headline inflation would become positive in 2009 Q4.

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. The most important external risk factor, in particular, was that global growth recovery prospects could be delayed. While the domestic risk factors were (1) Domestic political instability could manifest itself in the inability of the government to disburse the budget to stimulate the economy as effectively as planned; (2) The suspension of the Map Ta Phut industrial park project could affect investor sentiments and cause delays in the affected projects' revenue and investment. Therefore, the fan chart for economic growth would skew downward and widen compared to the last projection for the entire forecasting horizon, reflecting dominating negative risk factors and higher uncertainty. This gives the projection of economic growth in the ranges of (-3.5)-(-2.5) per cent in 2009 and 3.3-5.3 per cent in 2010, with probability of 78.2 and 75.7 per cent, respectively.

As for headline inflation projection, the MPC viewed that the downside risks would dominate the upside risks, as the economy could expand at a less brisk pace. Therefore, the fan chart for core inflation was skewed downwards for the entire forecasting horizon in line with the fan chart of the GDP growth. The MPC also viewed that the oil price risk will be balanced. Therefore, the headline inflation fan chart, which was partly determined by the dynamic of core inflation, would skew downwards as well.

The MPC projected headline inflation to average within the ranges of (-1.5)-(-0.5) per cent in 2009 and 3.5-5.5 per cent in 2010, with probability of 99.4 and 86.6 per cent, respectively. Meanwhile, core inflation was expected to be within the ranges of 0.0-0.5 per cent in 2009 and 1.5-2.5 per cent in 2010, with probability of 98.6 and 85.7 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 economic and financial conditions have improved on account of accommodative monetary policy stance and fiscal stimulus packages. Nevertheless, there remains uncertainty surrounding the global economic recovery, which is still reliant on sustained impetus from the fiscal stimulus. Meanwhile, the Thai economy continued to improve particularly in private domestic demand. However, the remains fragility coming from heightened domestic risk factors for instance in relation to the prospect for investment projects in the Map Ta Phut area. The MPC assesses that the Thai economy is expected to recover gradually, supported by the momentum of the global economy and accommodative monetary and fiscal policies. Meanwhile the inflationary pressure from the demand side continues to be subdued for the time being. The MPC therefore decided to maintain the policy interest rate at 1.25 per cent per annum at the 26 August 2009 and 21 October 2009 meetings.

Bank of Thailand
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