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Inflation Report July 2010

Mr. Paiboon Kittisrikangwan, Assistant Governor, Bank of Thailand (BOT), announced that the Monetary Policy Committee (MPC) released the July 2010 issue of the *Inflation Report* on 23 July 2010. 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 2010 Q1, the Thai economy expanded at a rate higher than previously assessed by the MPC. Main driving forces were exports and private investment, which expanded robustly in line with the global recovery. Although the political unrest in early 2010 Q2 adversely affected the tourism sector and, to a lesser degree, private spending, the overall impact on the broader economy was limited. As a result, manufacturing output and private sector spending continued to grow over the same period last year, though at a more moderate pace from the preceding quarter, while exports of goods accelerated in volume.

Barring the effects of government measures, inflationary pressure did not rise from the previous quarter. The slight pick-up in core inflation, however, was due to the base effect, as the negative contribution of the 15-year free-of-charge education program disappeared after the program had been effective for one year, together with the termination of the water fee subsidy since April. Meanwhile, headline inflation moderated in line with lower growth of domestic retail oil prices due to the high base in the preceding year when fuel taxes were raised and world oil prices picked up.

Economic growth and inflation projections

In forming economic and inflation forecasts for the next eight quarters, the MPC revised the key assumptions from those used three months earlier, as follows:

1. **Trading partners' economic growth** assumption was revised up for 2010, in line with the actual data indicating a robust and sustained recovery in trading partners' economies, especially those in Asia. The momentum was expected to moderate in 2011, however, to reflect higher uncertainty from the public debt problems in Europe.

2. The **Fed funds rate** assumption was unchanged from that in the previous *Report*, with the MPC expecting the FOMC to raise the rate from 2010 Q3 onwards.

3. **Regional currencies** were assumed to appreciate more against the US dollar throughout the projection period, as strengthening growth prospects in Asia would lead to the continuation of capital flows into the region. In addition, China's announcement of a more flexible exchange rate policy was likely to add upward pressure on regional currencies.

4. **Direct government spending** assumption for fiscal year 2010 was revised upwards from that in the previous *Report*, both for consumption and investment spending, owing to the upward revision of central government's disbursement rate as indicated by the actual data in the first half of the year. For fiscal year 2011, government

spending was revised up overall. Although the total budget remained unchanged, the higher-than-targeted government revenues in 2010 would allow for more principal repayment this year, leaving a larger share of the budget for stimulating economic activities in 2011.

5. The **Dubai oil price** stayed unchanged from the previous assumption, as fundamentals determining oil prices had not significantly changed from the previous *Report.* There was only a slight downward revision of Dubai oil price in 2010 Q2, following the actual data. As a result, the Dubai oil price was assumed to be at 79.8 and 87.5 USD per barrel in 2010 and 2011, respectively.

6. **Agricultural prices** were revised, moderating from the previous assumption in line with the actual prices in 2010 Q2, which turned out to be lower than expected due to the lower-than-assessed impacts of the drought on agricultural supply. On the other hand, **non-fuel commodity prices** were revised upward for 2010 following the global economic recovery, before subsiding in 2011 in line with the IMF forecasts of a substantial drop in prices of agricultural products from the preceding year.

7. The **minimum wage** assumption remained unchanged, staying at 206 baht per day throughout 2010 before rising slightly to 209 baht per day in 2011, in line with the economic recovery and higher inflation going forward.

Under the above assumptions and conditioning on domestic policy interest rate remaining at the present level of 1.50 per cent per annum over the next 8 quarters, the MPC assessed that the quarter-on-quarter momentum of the Thai economy would moderate in the second half of 2010 compared to the first half of the year, as a result of remaining domestic political tensions and softened global growth due to concerns over the public debt issues in Europe. Accordingly, exports and private investment would slow down after registering strong growth in the first half of the year, which would in turn constrict private consumption growth to some extent. Nonetheless, on a year-on-year basis, the Thai economy in 2010 was projected to expand at a rate higher than previously anticipated, mostly owing to the strong growth in the first half of the year. The growth momentum was also expected to carry on into 2011, with support from sound domestic economic fundamentals, good prospects of a continued global recovery, as well as improvements in consumer and investor sentiments. Going forward, the Thai economy would be driven by private domestic demand and the export sector.

With regard to inflationary pressures, the MPC projected both core and headline inflation in 2010 to be lower than forecasted in the previous *Report* from: (1) subsiding oil and commodity prices in line with softening global growth; (2) willingness of businesses to cooperate with the Ministry of Commerce in maintaining prices at prevailing levels until the end of 2010 Q3, in part due to the perceived fragility of domestic demand recovery; and (3) the government’s extension of some cost-of-living reduction measures to the end of the year. In 2011, the MPC expected slightly higher inflation compared to the previous projection, driven by demand pressure from the economic recovery and the narrowing output gap which would allow for more pass-through of rising production costs to retail prices. In addition, the termination of the government’s cost-of-living subsidy measures would contribute positively to inflation.

The MPC took note of risk factors that might cause the economy to deviate from the baseline projection. Overall, the MPC judged that uncertainties surrounding the growth projection were lower than that in the previous *Report*, with downside and upside risks becoming more balanced. This was mainly due to diminished domestic downside risks, as political tensions had been resolved to some degree. The global growth prospect, on the other hand, was to remain a major risk factor on the external front. Therefore, the fan chart for economic growth was balanced, compared to the downward-skewed one in the previous *Report* which reflected heightened political uncertainty at the time. Projection of economic growth was in the range of 6.5-7.5 per cent in 2010 and 3.0-5.0 per cent in 2011, with probabilities of 74.1 and 81.9 per cent, respectively.

As for the inflation projection, the MPC also assessed that upside and downside risk factors were roughly balanced. Hence, the fan charts for both core and headline inflation were drawn to be symmetric throughout the projection period. The MPC projected headline inflation to average within the ranges of 2.5-3.8 per cent in 2010 and 2.5-4.5 per cent in 2011, with probabilities of 93.9 and 84.7 per cent, respectively. Meanwhile, core inflation was expected to be within the ranges of 0.5-1.3 per cent in 2010 and 2.0-3.0 per cent in 2011, with probabilities of 99.2 and 91.9 per cent, respectively.

Monetary policy stance in the last 3 months

In the meeting on 2 June 2010, the MPC viewed that lowered risks to growth projection had rendered the particularly accommodative monetary policy less necessary. However, the impacts of the political unrest remained difficult to assess, and thus the MPC decided to postpone an increase in the policy interest rate. In the following meeting on 14 July 2010, the MPC assessed that the political impacts on the economy were limited and should not hinder economic growth, while inflationary pressure would rise in 2011 in line with the economic growth. As the exceptionally accommodative monetary policy stance became less necessary, the MPC decided to start adjusting the policy interest rate toward more normal levels by raising the rate by 0.25 per cent per annum, from 1.25 to 1.50 per cent per annum.

Bank of Thailand
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