



No. 45/2011

Inflation Report October 2011

Mr. Paiboon Kittisrikangwan, Assistant Governor Bank of Thailand (BOT), announced that the Monetary Policy Committee (MPC) released the October 2011 issue of the *Inflation Report* on October 28, 2011. The *Report* was published to enhance public understanding of the BOT's policy stance, with the key details summarized as follows.

Recent developments in inflation and economic conditions

The Thai economy contracted by 0.2 percent in 2011 Q2 from the preceding quarter, as private consumption and exports decelerated due to supply disruption, especially in April and May following natural disasters in Japan. The contraction was also partly attributable to a decline in public investment. Growth outlook then turned more positive in the third quarter, thanks to recovery in the automobile industry that benefited the export sector as well as the continued growth in investment and tourism. Private consumption, on the other hand, subsided as consumers delayed their spending awaiting the government's new stimulus measures. The widespread flood starting late in the quarter also affected agricultural production severely, further weighing on consumption momentum.

Inflation pressures continued to pick up in 2011 Q3. In addition to core inflation readings that gained mainly from prices of food and beverages, rising energy prices also added more upward pressures to headline inflation. Part of the acceleration in energy prices owed to the cutback in electricity charge subsidy. Moreover, domestic retail oil prices also remained elevated, despite moderating somewhat in the latter half of the quarter with lower global oil prices and the government's reduction on oil fund levy. At the same time, fresh food prices continued to edge higher but at a dampened pace due to unfavorable weather.

Economic growth and inflation projections

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

1. **Demand for Thai exports** is revised down throughout the projection period. Going forward, the MPC expects the global economy to remain plagued by the euro area's sovereign debt concern, especially the debt's ramifications on the banking sector and the real economy. Along with firmer recovery of the Japanese economy, the outlook for Asian growth remains favorable despite some impacts of supply chain disruption due to natural disasters.

2. The **U.S. federal funds rate** is assumed to remain at 0-0.25 percent throughout the forecast period, slightly revised from the previous view that anticipated a rise starting in 2012 Q2, in line with the protracted recovery in the U.S.

3. **Regional currencies** will depreciate against the U.S. dollar slightly more from the previous assumption. The uncertainty surrounding the euro area's sovereign debt crisis and the heightened risks to global growth overall may pressure regional currencies by inducing capital outflows from stock markets.

4. **Direct government spending** is revised down slightly for fiscal year 2011 following the actual disbursement, then raised for fiscal year 2012 thanks to the overall budget expansion in line with higher revenue projection, carry-over budget, and state-owned enterprises' investment. On top of the government's direct spending, the MPC's projection also incorporates additional stimulus measures in form of transfer expenses starting from 2011 Q4 onwards.

5. The **Dubai oil price** assumption is lowered from the previous one, averaging at 105 and 100 U.S. dollars per barrel in 2011 and 2012, respectively. This revision owes mainly to weakened global demand given the euro area's debt crisis and the U.S. economic slowdown. Nonetheless, upside pressures remain sizeable due to tightening global crude supply.

6. **Non-fuel commodity prices** are revised down, as weakened global demand leads to a decline in commodity prices. Over the period ahead, prices of food and metals should remain high due to limited supply expansion of these goods, thus driving the price assumption in 2012 to be higher than this year's.

7. **Domestic agricultural prices** are revised down for 2011 following a drop in prices of vegetables and fruits, given the high quantity of fresh produce during the second and the third quarter. However, the prices are expected to resume an uptrend in the fourth quarter, as agricultural areas are widely affected by the flood. The MPC then raises the price assumption in 2012, in tandem with an expected increase in rice price due to the government's pledging scheme for the 2011/12 rice crop.

8. The **daily minimum wage** assumption stays unchanged at 215 baht in 2011, then revised upward to 279 baht in 2012 in accordance with the National Wage Committee's decision to raise the daily minimum wage to 300 baht starting from 2012 Q2. The MPC then assumes this wage rate throughout the remaining projection period.

Based on the key assumptions above, the MPC projects the global economic growth to weaken going forward, given the heightened risks to the U.S. economy and the sovereign debt crisis in the euro area. The widespread flood, now affecting not only agricultural production but also manufacturing activity, is likely to weigh on the fourth quarter's growth substantially. Accordingly, the MPC lowers its growth projection for 2011 significantly from 4.1 to 2.6 percent. Provided that the flood situation resolves by the end of this year, the MPC expects domestic growth to recover in 2012 with key support from reconstruction spending, together with fiscal stimulus through the government's direct spending and additional measures such as rice pledging scheme and minimum wage raise. Under the baseline scenario, the MPC projects the Thai economy to grow by 4.1 percent in 2012 on the back of domestic demand recovery, the strength of which will make up for some anticipated loss in export momentum due to the global slowdown.

Meanwhile, the MPC revises down its headline inflation forecast for 2011 to 3.8 percent, largely owing to subdued cost pressures thanks to lower oil and commodity prices in the global market. Core inflation forecast, however, remains at 2.4 percent as previously projected. The MPC then raises its core and headline projections for 2012 to 2.5 and 3.5 percent, respectively. Without any significant change in the outlook for demand pressure, the upward revision reflects the impacts of recent government measures that are incorporated into the MPC's baseline forecasts for the first time - including minimum wage raise, rice pledging scheme, and excise tax on diesel fuel.

The MPC takes note of major risk factors that may cause growth to deviate from the baseline projection. On the whole, the MPC views downside risks to outweigh upside ones, with higher uncertainty from both domestic and external front. Accordingly, the fan chart for economic growth is wider and skewed to the downside throughout the projection period.

With respect to inflation, the MPC views downside risks to dominate upside ones, given that global oil and commodity prices may turn out lower than assessed in the baseline scenario. The government may also introduce additional price administration measures with an aim to support domestic recovery from the flood. Reflecting these risks, the fan charts for headline and core inflation are skewed downward over the entire projection period.

Monetary policy stance in the last 3 months

In its meeting on August 24, 2011, the MPC expected the slowdown in advanced economies to weigh on Thailand's exports. The negative impacts, however, were likely to be limited given Thailand's large intra-regional trade within Asia and diversification to alternative

markets. At the same time, the MPC viewed growth in domestic consumption and investment to sustain well. Despite some moderation in global oil and commodity prices, inflation pressures persisted as a result of robust demand expansion and fiscal stimulus. Therefore, the MPC voted 5 to 2 to raise the policy interest rate by 0.25 percent, from 3.25 to 3.50 percent, with two votes in favor of keeping the policy rate unchanged. Then in its subsequent meeting on October 19, 2011, the MPC viewed the global economic outlook to deteriorate markedly due to the impasse over the euro area's sovereign debt concern. This impasse also led to higher volatility in the financial market, with worries that the banking sector and the real economy would be gravely affected. On the domestic front, the MPC anticipated a positive growth for 2011 Q3, though latest data suggested some drag in exports due to weak global demand. The MPC also noted the severity of the flood, which had already interrupted economic activity in many areas, and expected growth for the rest of the year to be lower than previously anticipated. Resting upon solid fundamentals, the Thai economy would recover over the period ahead on the back of reconstruction spending and fiscal stimulus. Meanwhile, price pressures remained substantial because of robust demand expansion. The pressures were in spite of lower input costs including softened oil prices due to weakened global growth, and also in spite of stable inflation expectations that should lessen inflation pressures going forward. Nevertheless, upside risks to inflation would need to be monitored closely, given the likely acceleration in public and private spending after the flood situation abates. The MPC deemed the current level of policy rate to be appropriate in addressing upcoming inflation pressures and supporting economic adjustments amidst heightened risks from the global economy. Furthermore, the impacts of the flood on the broader economy were also not fully evident yet. The MPC thus decided on a 6-1 vote to hold the policy rate at the current level of 3.50 percent, with one vote in favor of a 0.25 percent rate decrease. The MPC would monitor upcoming developments closely and stood ready to take appropriate policy actions.

Bank of Thailand

October 28, 2011

For further information: Bodin Civilize Tel. 0 2356 7876 E-mail: bodinc@bot.or.th