



BANK OF THAILAND

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Excellency,

No. BOT.MPD.(21) 8/2559 Explanations for the movements of average headline inflation in 2015 breaching the lower bound of the inflation target

According to the Memorandum of Understanding between the Monetary Policy Committee (MPC) and the Minister of Finance dated December 25, 2014, the annual average headline inflation of 2.5 ± 1.5 percent was agreed upon as the monetary policy target for 2015. Should headline inflation breach the target, it is incumbent on the MPC to explain the reasons for the deviation, the appropriate monetary policy response, and the expected time frame to return inflation to the target. Subsequently, the MPC wrote an open letter to the Minister of Finance on February 2, 2015, explaining the reasons for headline inflation in January 2015 turning negative. The letter also stated a high probability of headline inflation for the year falling below the lower bound of the target, as crude oil prices had fallen rapidly and were projected to remain low for an extended period.

The average headline inflation for 2015, released by the Ministry of Commerce on January 4, 2016, was -0.90 percent, which is below the lower bound of the target. Consequently, in accordance with the above Memorandum, I am writing this open letter as Chairman of the MPC to describe: (1) the reasons why headline inflation breached the lower bound of the target; (2) the outlook for headline inflation and the expected time frame for headline inflation to return to the target; and (3) policy actions aimed at returning headline inflation to the target within an appropriate time horizon. Details are as follows.

Explanations why headline inflation was below the target

Headline inflation averaged -0.90 percent in 2015, below the 1 percent lower bound of the target and substantially below its historical average. The significant decline in headline inflation could be largely attributed to supply-side factors, namely movements in energy and fresh food prices that accounted for 92 percent of the difference between the average headline inflation for 2015 and its historical average (Table 1). Key developments are discussed below.

(1) **Oil prices sharply declined.** Crude oil prices plunged in 2014 Q4 and have remained subdued since. The average of the Dubai crude price in 2015 was 50.8 U.S. dollars a barrel, a drop of 47.5 percent from the 2014 average of 96.7 dollars a barrel, mainly on the back of rising global oil supply. Crude oil price developments reflect two

ongoing structural shifts in the crude oil market: (1) technological advancements that make shale oil production significantly cheaper and also faster in responding to changes in demand, and (2) major oil-exporting countries' intention to keep production at a high level in order to maintain their market share and oil export revenues. Meanwhile, global oil demand has remained subdued amid a gradual recovery in advanced economies and a slowdown in China and Asia. Plunging crude oil prices led to a sharp decline in domestic energy prices, especially retail petrol prices, constituting an important reason why headline inflation moved into negative territory. The decline in energy prices throughout 2015 accounted for 72 percent of the difference between the average inflation in 2015 and the historical average.

Incidentally, the depreciation of the baht against the U.S. dollar since 2015 Q2 somewhat delayed downward adjustments in domestic retail oil prices. The depreciation alone did not fully offset the impacts of falling crude prices, however.

Table 1: Contributions to headline inflation in 2015, compared with the 2000-2014 average, classified by categories in the headline CPI basket

Unit: percent	Historical average (2000 – 2014) ^{1/}	Annual average in 2015	Difference in percentage points (% contribution)
Headline inflation	2.58	-0.90	3.48 (100%)
Energy ^{2/}	0.74	-1.76	2.50 (72%)
Fresh food ^{3/}	0.80	0.11	0.69 (20%)
Core inflation ^{4/}	1.04	0.75	0.29 (8%)

Note: ^{1/} Calculated over the period during which Thailand adopted inflation targeting as its monetary policy framework.

^{2/} ^{3/} and ^{4/} Calculated by multiplying year-on-year percentage changes of average prices with weights in the CPI basket, using the weights of 11.40, 15.51, and 73.09 percent, respectively.

Source: Ministry of Commerce and calculations by the Bank of Thailand

(2) **Fresh food prices increased more slowly than normal.** This resulted largely from a moderated increase in the prices of eggs and pork, which caused the average increase in fresh food prices in 2015 to fall below its historical average. This factor played a secondary role behind the negative headline inflation, accounting for 20 percent of the difference between the average inflation in 2015 and the historical average.

(3) **Demand pressures remained low despite edging up somewhat.** Core inflation declined from the previous year due to: (1) Thailand's gradual economic recovery in line with a sluggish global recovery; (2) weakened purchasing power of some households due to falling farm prices and elevated household debt relative to the past; and (3) firms' limited pricing power. The drop in core inflation explained 8 percent of the difference between the average inflation in 2015 and the historical average.

Nonetheless, the MPC assesses the negative reading on headline inflation not to constitute deflation, as core inflation (excluding energy and fresh food prices) has remained positive and aggregate demand has continued to expand. More importantly, inflation expectations have remained close to the inflation target. According to the October 2015 survey of professional forecasters gathered by Consensus Economics, the 5-year-ahead inflation expectations stood at 2.6 percent despite a decline in short-term inflation expectations. This attests to the fact that the public perceived negative inflation only as temporary and that headline inflation would likely return to the target in the future.

The inflation outlook and the expected time frame for achieving the target

The MPC projects headline inflation to rise, turning positive within the first half of 2016 and reaching the lower bound of the target in the second half of the year, mainly on account of the dissipating base effect of previously high oil prices. Headline inflation is projected to attain the midpoint of the target within the next two years, as pressures from increasing demand following economic recovery should enable firms to raise prices. However, the pick-up in headline inflation is expected to be gradual, given limited cost pressures in line with crude prices that are expected to remain low. In the most recent *Monetary Policy Report*, released on December 25, 2015, the MPC projected headline inflation for 2016 to average at 0.8 percent, reflecting greater price pressures this year compared with the previous year. Nonetheless, uncertainties surrounding crude oil prices remain the key risk factor that can cause inflation to deviate both above and below the baseline projection.

At the meeting on November 4, 2015, the MPC proposed to keep the headline inflation target of 2.5 ± 1.5 percent as the target for 2016 and for the medium-term horizon. This is to reinforce commitment to the target and to reassure the general public that the MPC will take necessary policy actions to return headline inflation to the target within an appropriate time horizon without jeopardizing growth and macro-financial stability. The proposed monetary policy target was approved by the Cabinet on December 29, 2015.

Returning headline inflation to the target within an appropriate time horizon

Within the current monetary policy framework, the MPC aims at supporting the economy to achieve its potential, together with maintaining price and macro-financial stability. During the first half of 2015, the MPC provided further monetary easing by cutting the policy interest rate twice by 25 basis points each, resulting in a reduction from 2.00 percent to 1.50 percent that is near its historic low of 1.25 percent recorded during the Global Financial Crisis of 2008. The policy actions were aimed at fostering economic recovery and keeping the public's medium-term inflation expectations at the appropriate level.

Nevertheless, against the backdrop of last year's sharp decline in crude oil prices, many central banks experienced headline inflation breaching the target. The MPC recognizes that this was due primarily to an external factor beyond monetary policy control. Moreover, the MPC is fully aware of the long and lagged transmission of monetary policy actions to fully affect growth and inflation. Attempts to bring headline inflation back to the target within too short a time span, using excessively aggressive policy rate adjustments in terms of magnitude and speed, would likely have adverse consequences such as heightened financial market volatility and greater risks to long-term financial stability. Consistent with promoting sustainable economic growth, the MPC therefore seeks to return headline inflation to the target over an appropriate time horizon.

Looking ahead, the MPC sees the need for monetary policy to continue its current accommodative stance to support the ongoing economic recovery, which in turn would help raise headline inflation at the same time as downward pressures on inflation from oil prices begin to wane. The MPC expects headline inflation to reach the lower bound of the target during the second half of 2016 and to gradually attain the midpoint of the target within the next two years. Nevertheless, if warranted by future developments, the MPC stands ready to take appropriate actions to return headline inflation to the target within an appropriate time horizon in order to maintain sustainable economic growth and macro-financial stability.

To enhance transparency and clarity of our communication with the general public, the MPC wishes to publish this letter on the BOT's website. Please notify us at your earliest convenience should you deem otherwise.

Yours sincerely,

(Mr. Veerathai Santiprabhob)

Governor

Chairman of the Monetary Policy Committee

The Honorable Mr. Apisak Tantivorawong
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Bangkok