Unofficial Translation

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No. BOT.MPD.(02) 46/2561 Explanations for the average headline inflation in 2017 breaching the lower bound of the monetary policy target

According to the Memorandum of Understanding between the Monetary Policy Committee (MPC) and the Ministry of Finance dated December 7, 2016, the annual average headline inflation of 2.5 ± 1.5 percent was agreed upon as the monetary policy target for the medium-term horizon as well as the target for 2017. Should headline inflation breach the target, it is incumbent on the MPC to explain reasons for such deviation, an expected time frame for a return of inflation to the target, and appropriate monetary policy responses to maintain price stability going forward.

Headline inflation in December 2017, released by the Ministry of Commerce on January 3, 2018, registered at 0.78 percent. This resulted in an annual average inflation rate of 0.66 percent for 2017, which is below the lower bound of the monetary policy target. Consequently, in accordance with the above Memorandum, this open letter aims 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 a return of headline inflation to the target; and (3) monetary policy actions aimed at returning headline inflation to the target within an appropriate time horizon.

Key points are as follows.

(1) The principal mandate of monetary policy under the flexible inflation targeting framework is to stabilize inflation toward the predetermined target over the medium term. The setting of an explicit inflation target allows monetary policy to maintain price stability together with keeping economic activity in line with potential as well as preserving financial stability.

(2) Headline inflation remained below target in 2017 due mainly to supply-side factors, namely a decline in fresh food prices. Such condition did not pose deflationary risks nor limit Thailand's economic growth. Furthermore, the current level of inflation helped maintain the country's price competitiveness, while monetary policy conduct has anchored the public's inflation expectations near the midpoint of the target.

(3) Looking ahead, the MPC views that an accommodative monetary policy stance should be maintained for some time so that overall financial conditions remain conducive to strong economic growth, which will facilitate the return of headline inflation to target. At the same time, the MPC will pay attention to financial stability risks, which will be incorporated into the monetary policy decision-making framework in a more systematic manner. In addition, the MPC will continue to closely monitor and assess the impact of structural changes on inflation dynamics in determining monetary policy target and in the conduct of monetary policy going forward.

Details are as follows.

Explanations why headline inflation was below target

Headline inflation edged up since the end of 2016 until the beginning of 2017, prompting headline inflation to register above the lower bound of the monetary policy target in the first quarter of 2017. This was in line with the prior projections by the MPC, government agencies as well as private analysts that the annual average headline inflation for 2017 would stay within the target. Nevertheless, headline inflation declined significantly in the second and third quarters primarily due to lower fresh food prices, which were the key factor causing the annual average headline inflation to be below target. Key developments that contributed to low headline inflation are discussed below.

(1) Supply-side factors were primarily due to declines in fresh food prices which was attributable to the increased supply of agricultural output, notably vegetables and fruits, thanks to favorable weather conditions. Last year's high base following the drought also put additional downward pressure on fresh food prices, particularly in the second quarter of 2017 in which fresh food prices contracted by 3.0 percent from the same period last year, and caused fresh food inflation for 2017 to decline, averaging at –1.39 percent. In addition, the lower fresh food prices held down price increases in the food component in core inflation, which stood at only 1.14 percent. Given the share of all food products in Thailand's inflation basket was as high as 36.13 percent, this led to sluggish increases in both core and headline inflation.

Meanwhile, energy inflation for 2017 averaged at 4.85 percent, as rising global crude oil prices induced higher domestic retail oil prices. Nevertheless, this did not result in the acceleration of core inflation, as crude oil and energy prices remained low compared with the remarkably high level before 2015. Given lower production costs, firms' incentive to raise prices following the rise of oil and energy prices was limited.

(2) On the demand side, Thailand's economic growth gained further traction and continued to expand faster than expected, driven by a strong expansion of exports. However, the effects of growth improvement on headline inflation were limited owing to the gradual pace of domestic demand recovery. In particular, households continued their cautious spending pattern because employment and income had yet to fully benefit from overall economic expansion, while the level of debt of both agricultural and non-agricultural households remained elevated. Businesses, therefore, faced difficulties in raising prices. **Demand-pull inflationary pressure consequently**

remained subdued, causing the average core inflation for 2017 to remain at a low level at 0.56 percent. Going forward, the MPC assessed that when the Thai economy expanded further, demand pressures would increase accordingly, which enabled a return of headline inflation to target in the period ahead given the sufficiently accommodative monetary policy at present.

(3) Structural factors partly caused increases in inflation to be gradual despite the expansion of the Thai economy. Key structural factors included trade globalization that increased price competition and also enabled businesses to gain easier access to cheaper raw materials. Moreover, developments in production technology led to lower costs of production. The rising role of e-commerce also helped reduce distribution costs and at the same time enhanced price competition as consumers could easily compare prices. All these structural factors in fact took place globally and put downward pressure on both global and Thailand's inflation to stay below their historical average despite further improvements in the economic recovery. The MPC would continue to monitor and assess developments of those structural factors, which constitute an important input in the appropriate conduct of monetary policy, whereby changes in the relationship between inflation and economic conditions over time must be taken into consideration.

(Unit: Percentage changes from the same period last year)	Historical average (2010 – 2014)	2015	2016	2017
Headline inflation (100%)	**2.84**	**-0.90**	**0.19**	**0.66**
Fresh food inflation (15.69%)	6.47	0.71	2.47	-1.39
Energy inflation (11.75%)	5.77	-14.54	-7.22	4.85
Core inflation (72.56%)	1.61	1.05	0.74	0.56
Food component (20.45%)	*3.94*	*1.5*	*0.87*	*1.14*
Non-food component (52.11%)	*0.73*	*0.89*	*0.69*	*0.34*

Note: figure in ( ) denotes share in the inflation basket

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

The outlook for inflation and the expected time frame for a return to target

In the December 2017 *Monetary Policy Report* **the MPC projected headline inflation to edge up slowly, averaging at 1.1 percent in 2018, and reach the lower bound of the target within the first half of 2018.** The upward trajectory would be mainly supported by supply-side price pressures stemming from projected increases in both fresh food and crude oil prices in 2018, the latter due to further improvement in the global economic recovery as well as the agreement between OPEC and Non-OPEC producers to curtail oil production. **Meanwhile, demand-pull inflationary pressures**

were expected to gradually increase, since it would take some time for the expansion of the economy to fully and broadly affect household income and employment. The MPC, therefore, projected core inflation to be at 0.8 percent in 2018, compared with 0.6 percent in the previous year.

Nevertheless, the MPC assessed that uncertainties in both fresh food and energy prices were a key risk factor that could cause headline inflation to deviate from the baseline projection.

At the meeting on November 29, 2017, an agreement was reached between the MPC and the Ministry of Finance to keep the annual average headline inflation of 2.5 ± 1.5 percent as the monetary policy target for the medium term and as the target for 2018. This level of inflation would facilitate economic activity to be in line with potential. The proposed monetary policy target was then approved by the Cabinet on December 19, 2017. However, given that structural changes in both global and Thai economies could affect inflation dynamics and the inflation outlook, the Bank of Thailand (BOT) would monitor and assess the impact of those structural factors in determining monetary policy target and in the conduct of monetary policy going forward.

Monetary policy implementation to support the return of headline inflation to target over an appropriate time horizon

Under the flexible inflation targeting framework, the MPC's conduct of monetary policy aims to fulfill the price stability objective, while also seeking to attain sustainable economic growth and preserve financial stability. Hence, the MPC's monetary policy decisions must take into consideration the broad impact they might have on the economy and strike an appropriate balance to avoid any negative effects on macroeconomic stability over the medium and longer term. In addition, the conduct of monetary policy to attain price stability strives to see headline inflation within the target over the medium term rather than in the short horizon where inflation could be affected by various non-fundamental factors that would result in temporary deviations of inflation from target. In order to support the target fulfillment, monetary policy formulation would also take due consideration of the size and characteristics of shocks that affect inflation, the prevailing economic context and outlook at the time, as well as financial stability considerations so that appropriate policy actions would be taken to ensure that inflation would return to target within an appropriate time horizon.

The MPC assessed that headline inflation remained below target in 2017 due mainly to supply-side factors, namely the decline in fresh food prices, and that such condition did not pose deflationary risks nor limitations to economic growth. The Thai economy continued to grow faster than expected on the back of a strong expansion in exports of goods and services that was supported by the global economic recovery. In addition, signs of economic growth broadening to domestic demand were more evident. Meanwhile, headline inflation was on a positive trajectory over the past three years and was expected to gradually pick up in the period ahead before returning to the lower bound of the target in the first half of 2018. The public's inflation expectations also remained within the target. In addition, low inflation attributable to subdued global crude oil prices was considered a positive supply-side shock for the Thai economy which is a net oil importer, as it helped keep down costs of production and transportation for businesses as well as costs of living for households.

The MPC assessed that keeping the policy rate on hold at a near historically low level of 1.50 percent facilitated sufficiently accommodative financial conditions, as reflected in both the declines in bond yields and interest rates charged on new loans and the continued expansion in business financing through commercial bank loans and the capital market. Such accommodative financial conditions helped support the continuation of economic growth, the return of headline inflation to target, and the anchoring of the public's medium-term inflation expectations. The decision to keep the policy rate on hold also helped maintain policy space to deal with future shocks, especially those arising from the external front which could significantly affect the growth outlook of trading partners as well as Thailand's growth momentum.

The MPC viewed that additional monetary policy easing might not significantly bring about a faster return of headline inflation to target but instead might result in higher costs than benefits for the economy. In particular, low headline inflation was a result of both supply-side factors and structural factors that monetary policy could not directly influence. Attempting to raise inflation significantly over a short period of time might require substantial policy rate cuts which would in turn accelerate accumulation of financial vulnerabilities through further underpricing of risks. Meanwhile, the need for additional monetary policy easing declined as the Thai economy continued to gain further traction. In addition, a policy rate cut might negatively affect household savings in the long run, given that the share of households that either failed to fulfill, or had yet to commence, their retirement savings plans remained large and was on the rise.

The MPC and the BOT saw the need to implement additional policies and measures to support the strength of economic growth that would help stimulate demand-pull inflationary pressures. The MPC and the BOT also pushed forth regulatory measures to reduce vulnerabilities in the financial system, which would ease constraints in the conduct of monetary policy going forward. Measures implemented by the MPC and the BOT over the recent period include:

(1) Close monitoring of developments in the foreign exchange market and curbing excessive exchange rate volatility in some periods. Recently, the global economy faced a variety of risks that prompted volatile capital flows and affected the baht's movements. Against this backdrop, the MPC decided to manage exchange rate volatilities unwarranted by economic fundamentals, especially those during periods in which capital flows were large and driven by external factors. The MPC also approved the use of market-based instruments to curb capital flows and exchange rate volatilities, namely those aimed to address short-term baht speculation by foreign investors. For example, the size of short-term BOT bond issuance was reduced to discourage speculation. At the same time the behavior of foreign investors in the bond markets was monitored closely.

(2) Measures to bolster overall financial stability, thus reducing constraints upon monetary policy easing should the need arise in the future. The first of these was the implementation of measures to address high household debt such as enhancing regulation on credit card and personal loans under supervision as well as establishing a consumer debt relief program ("debt clinic") to help resolve complications associated with uncollateralized debt. Another measure was the collaboration with the Securities and Exchange Commission (SEC) to address growing concerns in the bond markets following a series of unrated bond defaults by some issuers. Consequently, the SEC revised the regulations on the issuance and sale of debt securities and improved operational standards of debt securities intermediaries to reduce problems arising from investors' underpricing of risks. To improve risk management practices by savings cooperatives, the BOT collaborated with government agencies to upgrade the legal framework and supervisory processes for savings cooperatives in order to keep up with current and future risks. Furthermore, the BOT saw the importance in strengthening cooperation with other financial regulators through joint policy meetings to promote greater efficiency among closely related regulatory agencies.

(3) Foreign exchange regulation reform. This effort aimed to provide investment alternatives for Thai investors as part of the capital account liberalization masterplan, facilitate more balanced capital flows, and improve the ease of doing business for the private sector. The reform covered a number of areas, including relaxation of regulations and expansion of investment limits on foreign securities for retail investors to accommodate growing demand for investment in securities abroad. In addition, the reform included the relaxation on documentation requirements by allowing qualified companies to execute foreign exchange transactions—such as money transfers for foreign investments, payments of goods and services, and other transactions related to business operations—without having to present supporting documents to commercial banks. The reform also extended to promoting the use of local currencies for trade and investment with neighboring countries, together with the removal of outdated rules and regulations that were no longer relevant in current economic and financial contexts.

(4) Measures to improve ability and know-how of SMEs in hedging against exchange rate risks. This effort aimed to raise awareness among SMEs the importance of exchange rate risk management and to better equip SMEs with experiences in using hedging instruments such as FX options. These measures partly helped reduce exchange rate volatilities and exchange rate pressures and improved capability of businesses in coping with exchange rate volatilities, both of which would play critical roles in strengthening economic growth and sustaining demand-pull inflationary pressures.

Looking ahead, the MPC views accommodative monetary policy should be maintained for some time so that overall financial conditions remain conducive to strong economic growth, which will facilitate the return of headline inflation to target, and at the same time takes into consideration financial stability risks. In addition, the MPC will continue to monitor and assess the impact of structural factors on inflation dynamics. The MPC stands ready to utilize available policy tools to ensure that headline inflation will return to target over an appropriate time horizon and that the public's medium-term inflation expectations remain well anchored, while at the same time preserving the country's 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.

Yours sincerely,

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