Unofficial Translation

BANK OF THAILAND

2 February 2015

Excellency,

No. BOT.MPD.(21) 180/2558 Explanations for the movements of headline inflation in January 2015 below the lower bound of the inflation target band

According to the Memorandum of Understanding between the Monetary Policy Committee (MPC) and the Minister of Finance on December 25, 2014, it is the MPC's responsibility to explain the reasons why headline inflation has moved away from the target of 2.5 +/- 1.5%, the period within which the Committee expects inflation to return to the target band, and how the Committee contemplates the appropriate monetary policy response.

For the past several months, retail oil prices have fallen steadily and led to a negative headline inflation rate in January 2015. Although this does not officially breach the inflation target which is set in the form of average annual headline inflation, the MPC deems it important to communicate with the Minister of Finance and the public regarding our views on the circumstance, to show commitment to the monetary policy framework and to guide public expectation of future inflation. As the chairman, I am writing this open letter on behalf of the MPC to convey the Committee's views as follows.

Explanation for a deviation of headline inflation from the target band and the MPC's assessment of the risks of deflation

Since the last quarter of 2014, global oil prices have dropped markedly due to rising global oil supply and sluggish oil demand in tandem with weak global recovery. Technological advances in oil drilling, especially from shale oil production, and the apparent decision by major oil exporters not to cut back production to support oil prices continue to weigh on the oil prices. This leads to falling domestic retail petrol prices and a steady decline in headline inflation. In January 2015, the headline inflation rate fell to -0.41%, and at the meeting on January 28, 2015, the MPC viewed that headline inflation would likely remain in the negative territory until the second quarter of 2015, should global oil prices continue to stay low.

Nonetheless, the MPC deems that the negative rate of headline inflation at present neither signals a deflationary environment nor constitutes risks to financial instability due to the following reasons:

(1) The decline in the price levels is not broad-based, but rather concentrated in energy-related products. The prices of other consumer's goods and services continue to show an upward trend, as reflected by both the current and projected positive core inflation. This is also in line with the MPC's assessment of growing domestic demand in 2015 and 2016.

(2) As a net oil importer, Thailand stands to benefit from a drop in global oil prices via lower production and transportation costs as well as lower cost of living. The reduced oil prices will thus further strengthen the recovery in domestic demand.

(3) Despite the fall in headline inflation, inflation expectations remain close to the inflation target. According to the January 2015 poll of market opinions gathered by Consensus Economics, forecasts showed a decline in short-term inflation but expected inflation six quarters ahead stood at 2.5%. This supports our assessment that the public views the current negative inflation rate as a temporary phenomenon.

Period within which the MPC expects headline inflation to return to the target band

The MPC assesses that headline inflation would become positive in the third quarter of 2015 and rise above the lower bound of the inflation target in the fourth quarter of 2015, following a projected rebound in global oil prices. The forecast of higher global oil prices is based on the assumptions of gradually falling global oil supply in response to lower oil prices as well as rising global oil demand from a pick-up in global growth. In addition, the expected and gradual recovery of the Thai economy should induce more demand-pulled inflationary pressure.

Nevertheless, there are potential risks to the forecast above which could cause headline inflation to be lower than the projected level. Key risk factors include global oil prices which could turn out to be lower than expected, adjustments in the domestic energy price structure which could lead to lower domestic petrol prices, and Thailand's economic recovery which could be weaker than expected.

The details of our official economic and inflation forecasts will be available in the next *Monetary Policy Report* to be published in March 2015.

Monetary policy action

Under the current monetary policy framework, the MPC gives priority to achieving the economy's potential growth in a sustainable manner, which entails containing risks to price stability and anchoring the public's inflation expectation at an appropriate level. That said, the MPC recognizes that it usually takes about 4-6 quarters before monetary policy actions fully affect economic growth and inflation. With a long policy lag, policy deliberation therefore pays attention to the inflation outlook over the next 1-2 years rather than the current inflation level. Moreover, policy deliberation on inflation focuses on the demand-induced pressure on the general price level rather than on the price of particular items, which could be caused by supply side factors beyond the influence of monetary policy.

Regarding the current situation, the MPC views the possible breach of the headline inflation target to be caused by a sharp fall in oil prices. As the MPC expects the global oil prices to gradually recover in line with a more balanced global oil market in the second half of 2015, headline inflation should rise accordingly and return to the official target band by the fourth quarter of 2015. Most importantly, the MPC considers the recent decline in headline inflation to have been a result of positive supply shocks, which will certainly provide an additional boost to the economy. Therefore, this should not raise concerns on risks of potential deflation, which is often caused by a contraction in aggregate demand. Indeed, there has been no evidence suggesting that the public expects a sustained decline in the general price level, which could lead to delays in consumption and investment. In addition, our current accommodative monetary policy stance will foster a continued economic recovery and therefore should, in part, help lift headline inflation back within the target band by year-end.

To enhance transparency and clarity of our communication with the general public, the Bank of Thailand will place this letter on our website for public dissemination. If you have other suggestions, please do notify us at your earliest convenience.

Yours sincerely,

(Mr. Prasarn Trairatvorakul)
Governor
Chairman of the Monetary Policy Committee

His Excellency
Mr. Sommai Phasee
Minister of Finance
Bangkok