BANK OF THAILAND

Unofficial Translation

April 8, 2022

Excellency,

No. BOT.MPD.(02) 275/2565 Statement pertaining to average headline inflation over the next 12 months residing above the upper bound of monetary policy target

On November 16, 2021, the Minister of Finance and the Monetary Policy Committee (MPC) mutually reached the agreement to set the monetary policy target for price stability such that headline inflation is to reside within the range of 1 – 3 percent for both the medium-term horizon and for the year 2022. The agreement also designated the MPC to write an open letter to the Minister of Finance should average headline inflation over the previous 12 months or a forecast of average headline inflation over the next 12 months breach the target range.

On March 30, 2022, the MPC assessed that average headline inflation over the next 12 months (from the second quarter of 2022 to the first quarter of 2023) would reach 4.1 percent and therefore would exceed the upper bound of the current monetary policy target. Pursuant to the above Memorandum, this open letter issued by the MPC shall outline (1) key drivers causing average headline inflation over the next 12 months to breach the target range; (2) potential time frame for headline inflation to revert to target; and (3) monetary policy actions taken to guide headline inflation back to the target within an appropriate time period. Details are as follows.

Key drivers causing average headline inflation over the next 12 months to breach the target range

The MPC assessed that average headline inflation over the next 12 months (from the second quarter of 2022 to the first quarter of 2023) would exceed the upper bound of the monetary policy target essentially due to cost-push shocks, while demand-pull inflationary pressures remain subdued (figure 1).

The build-up of inflationary pressures mainly stemmed from the following factors. First, **global supply shocks** that resulted from the Russia-Ukraine conflict led to surges in global energy and commodity prices, which in turn, significantly affected prices of domestic retail oil, liquefied petroleum gas, and electricity. Hence, over the next 12 months, average energy inflation was projected to rise to 16.8 percent—significantly higher than the average over the past five years of 1.6 percent. Second, **domestic supply shocks** from the African pig swine flu contagion as well as a higher degree of cost pass-through by businesses led to a rise in prepared food prices. Prices of other fresh food items were expected to slightly increase as well due to the higher costs of animal feed and chemical fertilizers following the Russia-Ukraine conflict. Consequently, fresh food inflation over the next 12 months was projected to reach 3.4 percent, which would be significantly higher than the average over the past five years of 0.6 percent.

Meanwhile, demand-pull inflationary pressures should remain subdued owing to weak domestic purchasing power amid the gradual economic recovery and the lingering uncertainty surrounding the COVID-19 situation, a fragile labor market, and an elevated level of household debt. Therefore, the ability for businesses to pass on the higher cost burden to retail prices would be limited, even after having faced with continuously rising costs since the second half of 2021 due to global supply disruptions and rising transportation costs. The MPC viewed that average core inflation over the next 12 months should rise to 2 percent, mainly from an increase in prepared food prices that followed from the shortage in pork supply.

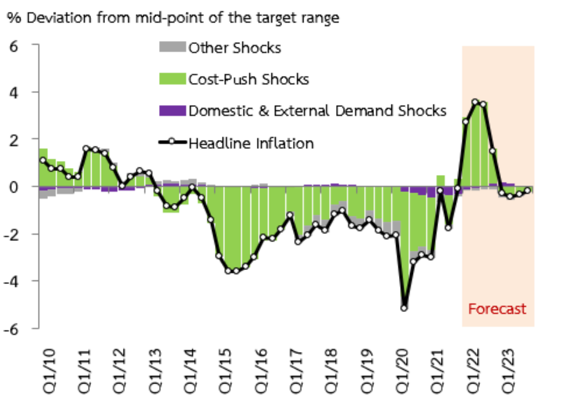
<u>Potential time frame for headline inflation to revert to target</u>

Headline inflation was projected to exceed 5 percent over the second and third quarters, followed by a decline in the latter part of 2022, and should reside within the monetary policy target range in early 2023. The rise of inflation in the second and third quarters of this year was due to the low-base effect stemming from lower oil prices and government relief measures in 2021. This would translate to relatively high inflation on the year-on-year basis for the second and third quarters of 2022 despite the fact that the price level would increase only somewhat over this period. Headline inflation was projected to decline in the fourth quarter of this year. Moreover, going forward, further increases in energy and food prices would be unlikely due to an expansion in oil supply from OPEC+ and the U.S., while the shortage of global raw materials and commodities should also be alleviated. As a result, headline inflation should reside within the monetary target range from early 2023 onwards (figure 2). Although some upside risks such as higher-than-expected oil prices and more intensive cost pass-through would remain present, the likelihood that headline inflation in 2023 would exceed the target range remained low. For such a breach to happen, there must be a more persistent surge in oil prices in conjunction with a higher degree of cost pass-through than expected.

Medium-term inflation expectations indicated by financial market data remained well-anchored within the target range, despite a rise in short-term inflation expectations following the recent price increases for certain goods. This reflected the belief that monetary policy would be able to maintain price stability over the medium term. This anchoring of medium-term inflation expectations was also evident in 2008 when headline inflation rose to 5.5 percent following a surge in global oil prices which peaked at 140 U.S. dollars per barrel. During that period, short-term inflation expectations were higher than 6 percent, while medium-term inflation expectations increased only slightly and remained within the target range. Such well-anchored inflation expectations would help reduce the risk of persistent price increases that could arise from second-round effects. At present there were no signs of the second-round effects.

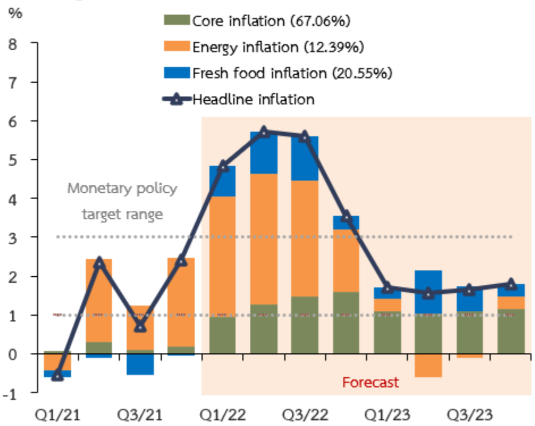
The MPC would continue to closely monitor risk factors that could lead to persistent price increases, notably the Russia-Ukraine conflict, global oil and commodity price surges, as well as cost pass-through by businesses. This would be to ensure that both inflation trend and medium-term inflation expectations remain well-anchored within the monetary policy target.

Figure 1: Headline inflation decomposition



Note: Calculated by Integrated Policy Macro Model
ที่มา: Ministry of Commerce calculated and forecasted by Bank of Thailand

Figure 2: Contribution to headline inflation



Note: ( ) is weight in CPI basket
Source: Ministry of Commerce calculated and forecasted by Bank of Thailand as of March 2022

<u>Monetary policy actions taken to guide headline inflation back to the target within an appropriate time period</u>

Given the monetary policy mandate of price stability, sustainable economic growth, and financial stability, the MPC would continue to place emphasis on supporting the economic recovery. The smooth economic recovery would foster employment and enhance business revenue as well as household income, which in turn could help cushion the higher cost of living. Meanwhile, given that the recent price increases stemmed primarily from cost-push factors which were highly volatile in nature and expected to subside over time, monetary policy, with a transmission lag of at least one year, should therefore look through these short-term volatilities and focus on ensuring that medium-term inflation trend would reside within the target range.

Looking ahead, the MPC viewed that government measures and policy coordination among government agencies would be critical in supporting the economic recovery amid high uncertainty. In particular, fiscal measures should be employed in a targeted manner to support the economic recovery, with a focus on enhancing income and easing the impact of the higher cost of living for vulnerable groups. Meanwhile, monetary policy should remain accommodative to support overall financial conditions. Moreover, financial and credit measures should help distribute liquidity and reduce debt burden, especially for those whose income had yet to fully recover. Financial institutions should promote sustainable debt restructuring in a way that would be consistent with the long-term debt servicing capability of borrowers. This would help enhance financial system stability and prevent it from hindering economic growth going forward. The MPC would closely monitor key factors affecting economic growth and would stand ready to take further monetary policy actions and employ appropriate tools if necessary to support the economic recovery while pursuing price and financial stability.

According to the latest Memorandum of Understanding between the MPC and the Minister of Finance, the MPC will write an open letter to the Minister of Finance again six months from now, should the average headline inflation over the past 12 months or the forecast of the average headline inflation in the next 12 months at that time breach the monetary policy target. In addition, to enhance the transparency and clarity of BOT's communication to the general public, the MPC wished to publish this letter on the BOT's website.

Yours sincerely,

(Mr. Sethaput Suthiwartnarueput)
Governor
Chairman of the Monetary Policy Committee

The Honorable Mr. Arkhom Termpittayapaisith
Minister of Finance
Bangkok