BANK OF THAILAND

Unofficial Translation

October 6, 2022

Excellency,

No. BOT.MPD.(02) 997/2565 Statement pertaining to average headline inflation over the previous and the next 12 months residing above the upper bound of the 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.

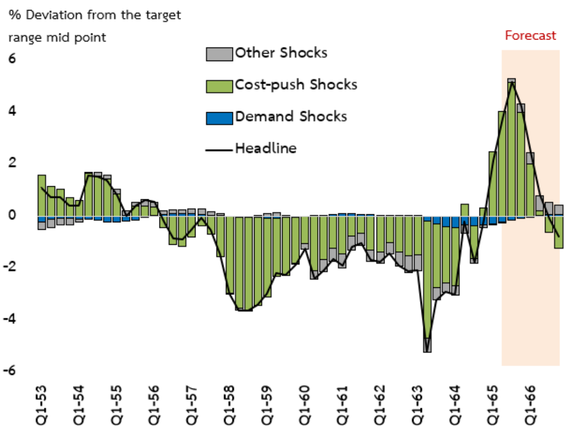
On October 5, 2022, the Ministry of Commerce released the September 2022 headline inflation rate of 6.41 percent, leading to an average headline inflation rate over the previous 12 months (October 2021 – September 2022) of 5.23 percent—well above the target range. Moreover, for the meeting on September 28, 2022, the MPC assessed that average headline inflation over the next 12 months (fourth quarter of 2022 – third quarter of 2023) would reach 3.9 percent, residing above the target range as well. Pursuant to the aforementioned agreement, this open letter issued by the MPC shall outline (1) key drivers causing average headline inflation over the previous and the next 12 months to breach the target range; (2) the potential time frame for headline inflation to revert to the 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 that caused average headline inflation over the previous and next 12 months to exceed target range

The main reason that caused average headline inflation over the past 12 months to reside above the upper bound of the monetary policy target range was due to cost-push shocks, while demand-pull inflationary pressures played a limited role. While cost-push shocks have dissipated to some extent, these supply-side pressures remain high and could drive average headline inflation over the next 12 months above the target range. In addition, core inflation going forward could face some upward pressure stemming from higher cost pass-through in the face of recovering demand.

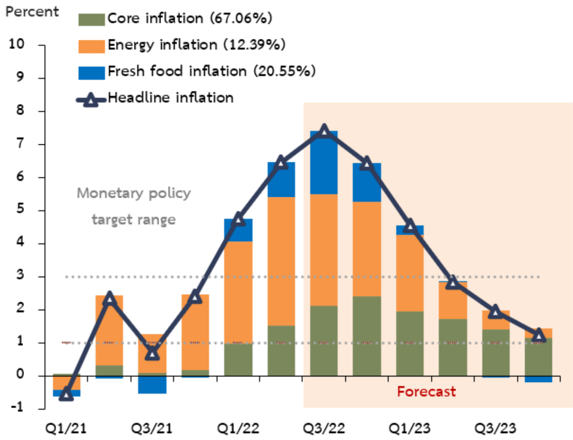
Over the past 12 months, average headline inflation of 5.23 percent exceeded the monetary policy target range mainly due to the following supply-side factors. (1) Global supply shocks following the Russia-Ukraine conflict which led to surges in **global energy and commodity prices**. These supply shocks significantly affected prices of domestic retail oil, liquefied petroleum gas, and electricity. Together with the low base effect from the government relief measures implemented in 2021, average energy inflation in the past 12 months rose as high as 26.76 percent. **(2) Domestic supply shocks** from the African swine flu led to an increase in pork prices following supply reduction while fresh food prices also surged due to higher animal feed and fertilizer costs. These price pressures led to an **average fresh food inflation rate** of 4.41 percent over the past 12 months. Subsequently, higher food costs were passed through to the price of prepared food, which contributed significantly to a rise in core inflation. As shown in Figure 1, these supply side factors primarily drove headline inflation while **demand-pull inflationary pressures remained quite subdued**. This can be attributed to (1) weak domestic purchasing power of consumers amid the gradual economic recovery, (2) a fragile labor market, and (3) an elevated level of household debt. Consequently, the ability for businesses to pass on the higher cost burden to retail prices had been limited.

Figure 1: Headline Inflation Decomposition



Source: Calculated and estimated by Bank of Thailand in MPC meeting on 28 September 2022 using Integrated Policy Macro Model

Figure 2: Contribution to Headline Inflation



Note: ( ) is weight in CPI basket

Source: Ministry of Commerce; Calculated and forecasted by Bank of Thailand in MPC meeting on 28 September 2022

Over the next 12 months, average headline inflation was projected to be 3.9 percent and would remain above the monetary policy target range. As shown in Figure 2, prominent drivers would still be from supply-side factors. Despite the recent decline in most of the energy prices, energy inflation was estimated to remain high at 12.4 percent, while fresh food inflation should decline to 1.7 percent. As for core inflation, the average rate over the next 12 months was expected to be 2.9 percent, higher than its five-year average of 0.46 percent. This higher-than-average core inflation projection reflects the view that the Thai economy should recover more strongly in 2023—with GDP growth expected to be around 3.8 percent. With such economic recovery being intact, businesses would be able to pass on more costs to consumers, leading to higher prices.

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

The MPC assessed that headline inflation would peak in the third quarter of 2022 and would gradually decline in the fourth quarter of the same year. With such trend, headline inflation was expected to reside within the monetary policy target range by mid 2023. This momentum can largely be attributed to the dissipation of the following supply-side pressures. First, further acceleration in energy prices would be unlikely due to potentially lower global demand over concerns of a global slowdown and an increase in oil supply especially from the U.S. Second, fresh food prices were expected to decline as the livestock supply gradually returned to normal, while the costs for animal feed and fertilizer should ease off due to the unwinding of supply chain bottlenecks and global logistic difficulties. Reduction in these cost pressures would reduce the likelihood of intensive cost pass-through and consequently accelerated core inflation.

Moreover, medium-term inflation expectations implied 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 beliefs of market participants that monetary policy would be able to maintain price stability over the medium term. Well-anchored inflation expectations would be critical in reducing the risk of persistent price increases that could arise from second-round effects. **However, the MPC would continue to closely monitor risk factors that could potentially lead to persistent price increases** such as price pressures stemming from geopolitical conflicts, global oil and commodity price volatility, supply-chain disruptions and global logistic problems, as well as higher cost pass-through by businesses to core inflation. This is to ensure that underlying trend inflation and medium-term inflation expectations would remain well-anchored within the monetary policy target range.

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

Under the monetary policy mandate of price stability, sustainable economic growth, and financial stability, the MPC viewed that the Thai economic recovery had continued to strengthen, lessening the need for extraordinarily accommodative monetary

policy. As a result, the MPC began to raise the policy rate to achieve a level that would be consistent with sustainable growth in the long term. Policy normalization should be done in a gradual and measured manner to keep the recovery intact while reducing the risk of having broad-based and persistent inflation that could stem from larger-than-expected demand-pull pressures. Moreover, the MPC is ready to adjust the size and timing of policy normalization should the growth and inflation outlook shift from the current assessment.

In addition, the MPC deemed it important to continue implementing targeted measures and sustainable debt resolution for vulnerable groups. Targeted financial and credit measures would help distribute liquidity and reduce the debt burden of fragile borrowers. In addition, employing the sustainable debt restructuring program consistent with the long-term debt serviceability of borrowers would lead to sustainable debt resolution, enhancement of financial stability as well as preventing debt from hindering the economic recovery going forward. In addition, the MPC would closely monitor key factors affecting economic growth and inflation trends and would stand ready to take further monetary policy actions and to employ appropriate tools if necessary.

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 average headline inflation over the past 12 months or a forecast of 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