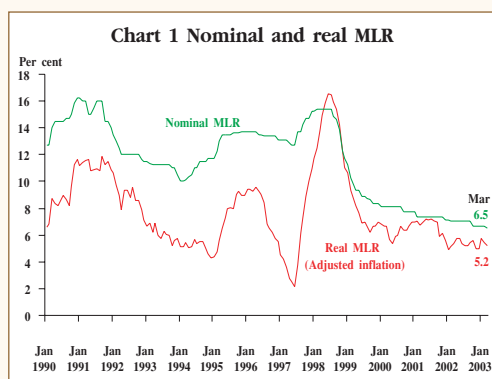


Explaining Real Interest Rates in Thailand

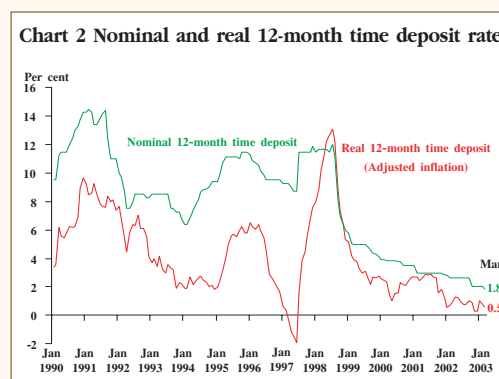
The BOT's adoption of an accommodative monetary policy stance to support growth-as reflected in the reduction in the 14-day repurchase rate from 2.25 per cent per annum at the beginning of 2002 to 1.75 per cent per annum currently-has brought about corresponding declines in commercial banks' retail rates and given rise to some concern about possible adverse implications of low deposit interest rates, especially in real terms, on savers who rely significantly in interest income. The MPC therefore saw the need to establish a common understanding of the concept of real interest rates and its determinants.

The real interest rate represents the true economic cost of borrowing and lending, expressed in terms of real goods and services rather in money terms. It is calculated as the nominal interest rate minus expected headline inflation, where the latter depends on how the public form their forecasts of future inflation. In the BOT macroeconomic model, forecasts of inflation are assumed to satisfy "rational expectations" and incorporate both forward and backward looking behaviour as well. For policy work, the BOT uses these forecasts of inflation to construct measures of real interest rates. Since the decisions of savers and investors in an economy are predicated on their expectations about the future, it is important to use expected inflation to construct real rates and the common practice of adjusting nominal interest rates by current inflation is not entirely satisfactory.

Real lending and deposit interest rates, calculated using the method described above, have indeed followed a downward trend since the beginning of 1999. At end March 2003, the real deposit rate was 0.5 per cent per annum while the real lending rate stood at 5.2 per cent. Notably, real deposit rates are currently at their lowest levels since 1990 (excluding the 1997 crisis period), where rates fell to 1.1 per cent, while the real MLR lending rate remains higher than the corresponding level in the same period.



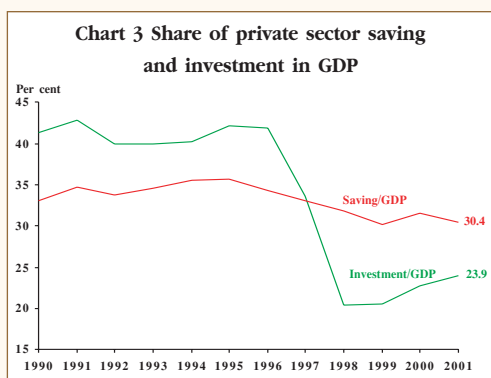
Source: Bank of Thailand



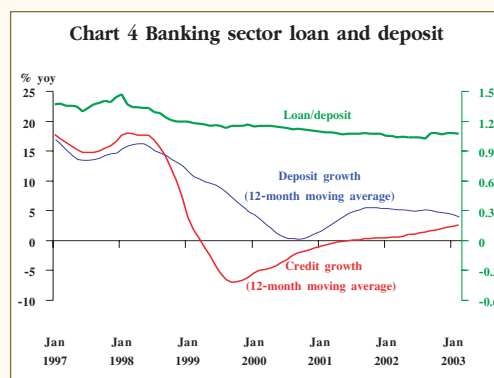
Source: Bank of Thailand

The main factor behind low real interest rates in Thailand is the sharp fall in investment spending following the crisis in 1997. With the suspension of many projects and investors becoming more selective in undertaking new projects, demand for capital declined significantly as reflected in the sharp reduction in gross domestic investment as a ratio of GDP from over 40 percent before 1997 to around 25 percent in recent years. By comparison, gross national savings has declined only modestly as a share of GDP over the same period. This contrasting experience between investment and saving is one of the key factors behind low real interest rates.

This divergence between demand for and supply of funds has been exacerbated by problems in the banking sector, which has been unable to revive growth in their most productive asset, loans. This, in turn, has limited their ability to offer higher return on deposits. At the same time, a lack of saving diversification, related to the limited opportunities currently available to invest in alternative assets, has resulted in higher liquidity in the banking system and downward pressure on interest rates.



Source: Bank of Thailand



Source: Bank of Thailand

The real interest rate is an important determinant of households' saving and spending pattern. For savers, the fall in real interest rates has two main effects: 1) price effect through which the fall in real interest rates encourages spending and reallocation of funds towards other assets such as equity or bonds; and 2) income effect through which a reduction in real income of savers, especially those that rely substantially on interest income, may dampen spending. For borrowers, on the other hand, the income effect is positive as lower real rates help to ease the debt burdens. At the same time, low interest rates help to encourage business investment and consumer spending on durable goods, as reflected in the recent surge in passenger car and motorcycle sales, as well as the steady growth in consumer credit. Low interest rates also encourage depositors to look for alternative investment, which may boost asset prices and help, in turn, to support economic growth by improving firms' balance sheets and raising consumption through positive wealth effects.

With respect to monetary policy, real interest rates play an important role in the monetary transmission mechanism. In particular, given sluggish price adjustment, a policy-induced change in short-term nominal interest rates leads to a temporary change in real interest rates in the same direction, which, in turn, affects real consumption and investment decisions. It is also often necessary for central banks to consider the real interest rate as part of their assessment of the monetary policy stance. For instance, a constant nominal policy rate together with an upward trend in inflation implies that the monetary stance gets looser over time even with no change in policy as real interest rates fall. Thus, by controlling for the effects of inflation, the real interest rate is sometimes a more reliable indicator of the policy stance than the policy instrument itself.

To summarize, real interest rates do not only reflect the fundamental state of the economy, they also serve as an equilibrating force that helps to stabilize economic activity around its potential level. During a boom the scarcity of funds pushes real interest rates up, which tends to dampen investment and consumption spending. The opposite happens during downturns. From a policy perspective, it is therefore important to let, and sometimes encourage, real interest rates to vary over the business cycle.