Liquidity in Thailand's Financial Market and Implications for Monetary Policy

Over the past 3-4 years, a frequently cited problem in Thailand's financial system is that of 'excess liquidity'. However, popular discussion of the latter is often clouded by the absence of a clear definition of what 'excess liquidity' is. This box attempts to provide a conceptual framework for the discussion of liquidity in Thailand's financial system and highlights some implications for policy of the current situation.

Excess Liquidity in the Financial System

Excess liquidity in Thailand's financial system can be divided into 2 parts:

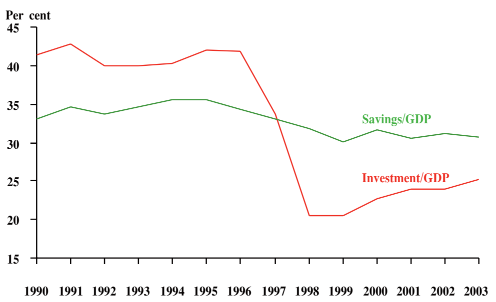
1. *Structural excess liquidity of the economy* is a manifestation of an unusually low credit to deposit ratio. There are many factors that can give rise to such situation. On the demand side, weak investment recovery diminishes the demand for loans. At the same time, the supply of loans may be constrained by higher risk-aversion on the part of banks in response to a sharp increase in non-performing loans. Moreover, the steady rise in deposits can be partly attributed to a lack of willingness and/or ability on the part of savers to diversify their savings into alternative channels.

In the case of Thailand, the sharp decline in investment after the 1997 crisis against the background of a relatively stable saving behaviour led to a substantial savings-investment gap, which has also been reflected in the current account surplus. To a large extent, the excess of savings over investment has manifested itself in the banking sector in the form of a historically low credit to deposit ratio. The latter is reflective of Thai households' saving behavior whereby bank deposits are generally seen as the most attractive channel of saving. Lack of knowledge as well as ability to invest directly in alternative higher-yielding assets also reinforces the reliance on bank intermediary

From the perspective of commercial banks, the plentiful supply of deposits relative to a still-limited ability to expand their loan portfolios has pushed banks to expand their investments in the bond, equity, and money markets.

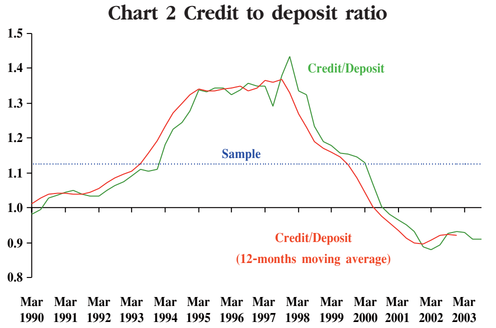
2. *Market excess liquidity* refers to financial institutions' investments in the money market, be it the

Chart 1 Savings and investment to GDP ratios



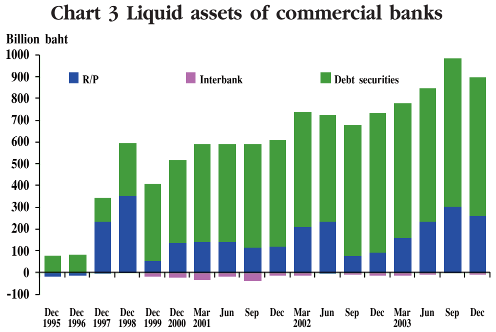
Source: NESDB

Chart 2 Credit to deposit ratio



Source: Bank of Thailand

Chart 3 Liquid assets of commercial banks



Source: Bank of Thailand

repurchase market, the interbank market, or the swap market that is *over and above* the typical allocation that would occur as part of normal liquidity management and contributes to a situation in which financial institutions as a whole are net lenders in the money market. Such excess liquidity reflects not only commercial banks' management of structural excess deposits outlined above, but also the borrowing needs of the Financial Institutions Development Fund (FIDF) - whose losses are refinanced continuously through the repurchase market - as well as sterilization operations conducted by the Bank of Thailand.

Implications for Policy

The two types of excess liquidity discussed above have different implications for monetary policy as follows:

1. Structural excess liquidity of the economy has direct repercussion on commercial banks' profitability as funding costs are kept high by continued growth of the deposit base while growth in their highest earning asset, loans, remains sluggish. In addition, the plentiful supply of deposits implies that the degree of competition among banks for funds is low.

2. A by-product of excess market liquidity is that commercial banks, as a whole, are net lenders in the money market. As a result, changes in short-term interest rates, which the Bank of Thailand can influence closely, do not impact directly on banks' cost of funds but instead affect their returns on investment. In this setting, the influence of short-term interest rates on banks' retail deposit and lending rates is somewhat diminished.

Impact of a 1% increase in the 14-day repurchase rate on deposit and lending rates

Interest rates	Sample	Impact horizon			
		Immediate	3 months	6 months	Long-run
3-month deposit rate	Jan 1980 - Dec 1995	0.057	0.402	0.612	0.700
	Jan 1980 - Dec 2003	0.059	0.311	0.395	0.420
MLR lending rate	Jan 1980 - Dec 1995	0.089	0.328	0.521	0.558
	Jan 1980 - Dec 2003	0.042	0.240	0.356	0.387

Source: Disyatat P. and P. Vongsinsirikul (2002) "Monetary Policy and the Transmission Mechanism in Thailand", Bank of Thailand Discussion Paper, October 2002 (re-estimated using the latest data).

Overall, with virtually no competitive pressure for deposits but a very high degree of competition on loan extension, the existence of excess liquidity in Thailand's financial system implies that the pass-through from short-term interest rates to banks' retail interest rates is weaker and more drawn-out than usual. This conclusion is consistent with the empirical research conducted by the Bank of Thailand which found that the degree of interest rate pass-through in Thailand has fallen after the 1997 crisis at every horizon.

Trends in Excess Liquidity Going Forward

Going forward, excess liquidity in the Thai financial system should decline as the low interest rate environment helps to support a recovery in investment, and thus loan demand. Greater reallocation of savings from deposits to other channels of investment, such as equities and bonds, should reinforce this process. At the same time, as new government bonds are issued to fiscalize losses of the FIDF in accordance with the plan set out in 2002, its borrowing needs from the money market will be reduced, thereby helping to strengthen interest rate pass-through as well as the overall monetary transmission mechanism of the Bank of Thailand.