

Excess Liquidity in the Financial System

In the previous *Inflation Report* (April 2004), the Box titled “Liquidity in Thailand’s Financial Market and Implications for Monetary Policy” provided a conceptual meaning of liquidity and its implications for monetary policy. The Box, however, did not make specific assertions regarding the measurement of excess liquidity. As the definition of excess liquidity varies among various analysts, and commercial banks’ liquidity is an indicator of commercial banks’ readiness in adjusting interest rates, an estimation of excess liquidity in the financial system is thus needed for an effective conduct of monetary policy.

Considering the balance sheet of commercial banks, assets can be classified into various types, those that can easily be converted into cash will be referred to here as **disposable liquidity**. In general, one part of disposable liquidity is assets that commercial banks use for their own investment management. The other part is liquid assets that exceed the commercial banks’ investment demand, but are expected to be invested in higher-yielding assets in the future, referred to here as **excess liquidity**.

Disposable Liquidity

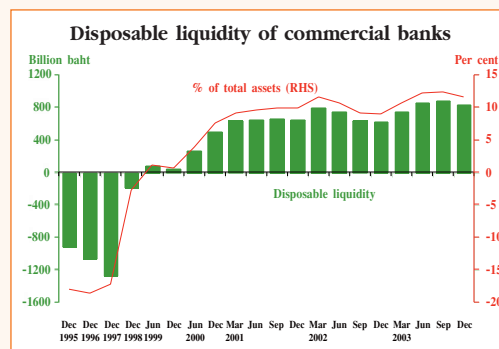
To be more precise, disposable liquidity represents any type of commercial banks’ assets that can be easily converted into cash when needed. Consequently, in considering the asset side of a commercial bank’s balance sheet, assets corresponding to the aforementioned definition include:

1. securities, namely, government bonds, Treasury bills, BOT bonds, FIDF bonds, private debentures, state enterprise bonds, and specialised financial institutions bonds;
2. net lending in the repurchase market, namely, the difference between loans and borrowings of commercial banks in the repurchase market; and
3. net foreign assets.

Disposable liquidity	
As of April 2004	Million baht
Assets	
Credits (excluding interbank)	4,902,381
Securities	975,133
o/w Government bonds & BOT bonds	407,032
Net foreign assets (excluding credits)	161,711
Net lending in R/P market	273,583
Cash in hand & deposits at BOT	128,733
Other assets	573,541
	7,015,082

842,326

Source: Bank of Thailand



Source: Bank of Thailand

During the pre-crisis period, commercial banks experienced negative disposable liquidity, reflecting the economic conditions when commercial banks extended excessive credits to the economy such that no disposable liquidity was available. Moreover, commercial banks borrowed money from abroad to lend domestically. Thereafter, disposable liquidity has remained quite high during the post-crisis period, standing at 800 billion baht as of April 2004.

Disposable liquidity reflects assets of commercial banks that are in part needed for investment and daily liquidity management and in part used for temporary investments when banks are not ready to give out loans. Normally, returns on these temporary investments are low compared to those from loans, and as a result, excess liquidity has increased.

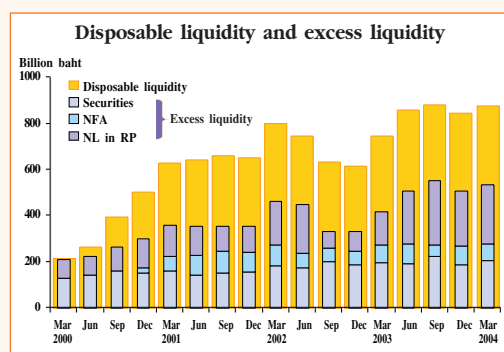
Excess Liquidity

Excess liquidity is the part of disposable liquidity beyond that needed by the commercial banks for investment and daily liquidity management, with no credit extension obligation and hence can be invested temporarily. However, each commercial bank holds different proportions of excess liquidity depending on each bank's management policy. It is thus difficult to assess how each commercial bank will arrange their portfolio or how much excess liquidity they will hold under normal credit extension conditions. Following discussions with treasurers of commercial banks, the BOT calculated excess liquidity under different assumptions as follows:

	Assumption 1	Assumption 2	Assumption 3
Securities	50 per cent of government bonds and BOT bonds	Short-term available for sales bonds	Credit to deposit ratio at 95 per cent
Net investment in the repurchase market	90 per cent	90 per cent	
Net investment in foreign assets	40 per cent	40 per cent	

Source: Bank of Thailand

Assumptions 1 and 2 are different in terms of security holdings of commercial banks. Under assumption 1, banks hold 50 per cent of government and BOT bonds as excess liquidity, while under assumption 2, only short-term available for sales bonds are considered excess liquidity. However, both assumptions 1 and 2 consider 90 and 40 per cent share of net investments in the repurchase market and foreign assets, respectively, as excess liquidity.



Source: Bank of Thailand

Using the 3 assumptions above, current excess liquidity is estimated to be around 400-500 billion baht and is expected to remain steady. Excess liquidity, on the other hand, can also represent money that banks invest in BOT's open market operation instruments. If banks are in need of liquid assets, the BOT will have to provide that liquidity with no objection. These instruments include: (1) net investment of commercial banks in the repurchase market, (2) outstanding net buy-sell swaps between commercial banks and the BOT and (3) BOT bonds held by commercial banks.

Although excess liquidity is currently high, continuously strong Thai economic growth driven by private investment will help accelerate the credit trend. In addition, the Ministry of Finance's plan to issue savings bonds of 70 billion baht to fiscalise FIDF losses in August 2004 will reduce the need for commercial banks' to invest in the repurchase market. These factors will lessen excess liquidity in the financial system and enhance the effectiveness of BOT's monetary policy transmission to financial institutions.