

Monetary transmission via the interest rate channel

The effectiveness of monetary policy depends crucially on the transmission of a policy change to output and ultimately to inflation. The monetary transmission process begins with the central bank announcing a policy action and engaging in open market operations to bring money market interest rates in line with the policy rate. From there, monetary transmission may proceed through several channels, for instance the interest rate channel, the exchange rate channel, the asset price channel, and the expectations channel (for more details on monetary transmission channels, see the October 2004 issue of the *Inflation Report*).

Interest rate pass-through in Thailand

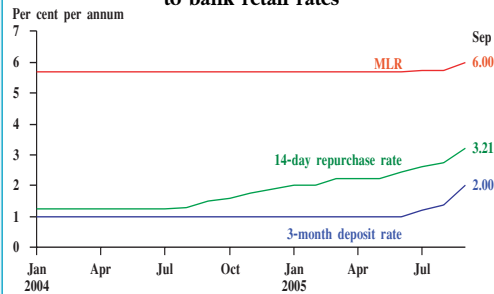
The interest rate channel is the primary channel through which monetary policy operates in Thailand. This is because households and firms still rely significantly on banks as a source of financing for consumption and investment. The monetary transmission via the interest rate channel can be described as follows. Suppose the central bank raises the policy rate. First, money market interest rates will rise as a result of the central bank's open market operations. Second, the term structure of interest rates will change according to expected future short-term interest rates. Third, retail interest rates of commercial banks will rise in accordance with the term structure of interest rates. Fourth, given price stickiness in the short run, long-term real interest rates will rise. It is this final development that will slow down consumption and investment of households

and firms because of the increased opportunity cost.

Until recently the pass-through from policy and money market rates to retail rates of commercial banks was sluggish in Thailand. Chart 1 shows that, although the policy rate started to move upwards in August 2004, retail rates only began to adjust in May 2005. The slow pass-through is due to a high level of excess liquidity in the banking system that is a legacy of the 1997 financial crisis. Nevertheless, banks began to raise their retail rates significantly in response to policy rate hikes in September 2005, making it likely that the monetary transmission through the interest rate channel will become faster. Two key factors that explain the strengthening of the interest rate channel are as follows.

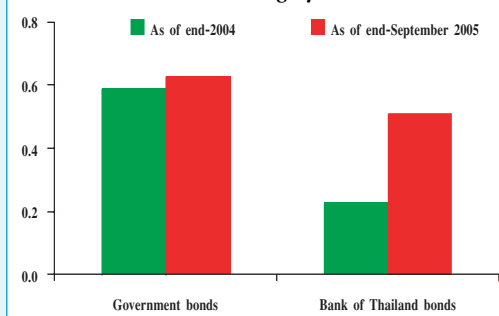
The first factor has to do with households and firms shifting their portfolios out of bank deposits and the associated decision by some banks to mobilize

Chart 1 Interest rate pass-through from policy rate to bank retail rates



Note: Average of 4 largest banks
Source: Bank of Thailand

Chart 2 Share of bond holding by the non-bank sector



Source: Bank of Thailand

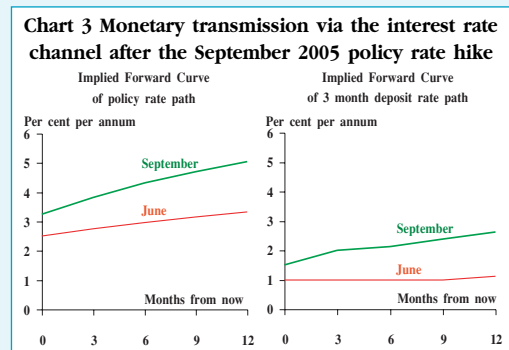
deposits. Regarding the slowdown in the supply of deposits, households and firms have moved away from bank deposits to alternative saving instruments (e.g., government bonds) with higher rates of returns. Chart 2 shows that the share of non-banks' holding of government and Bank of Thailand bonds increased markedly between end-2004 and end-September 2005.

As for deposit interest rates, although overall excess liquidity in the financial system remains high, small- and medium-size commercial banks with low excess liquidity need to expand their deposit base already in preparation for demand for loans accompanying an anticipated increase in investment. Consequently, banks with fairly large excess liquidity have to raise their rates too for fear of losing their depositors. As for lending rates, with the increasing need for financing in the future and with the term structure of interest rates that has already shifted upwards, banks are able to raise their lending rates without significantly losing clients. In short, the expected reduction in stickiness of both deposit and lending rates will lead to a higher interest rate pass-through.

The second factor that explains a higher interest rate pass-through involves strategic moves by banks. Aware of the interest up-cycle consistently signalled by the central bank, it is cost effective for banks to lock in their interest payments by raising deposit rates now instead of later to expand their deposit base. Were they to wait until interest rates rise further, they would be forced to offer higher rates to bring in new customers.

Latest developments

An important factor explaining why the 50 basis-point hike in the policy rate on 7 September 2005 led banks across the board to react swiftly is the change in expectations about the pace of future policy rate increases



Source: Bank of Thailand

that is likely to be faster. The left panel of Chart 3 shows that, at end-June 2005 (before the September rate hike), the market anticipated that the policy rate would rise only with a moderate speed. This resulted in banks expecting to keep their 3-month deposit rate* unchanged in the next 12 months, as shown in the right panel. However, after the 50 basis-point rate hike, at end-September 2005 the market expected that the policy rate would rise by a faster pace, causing banks to start raising their retail rates. Incidentally, as the process of policy rate increases becomes more dynamic, commercial banks on the whole face greater uncertainty and greater risks of losing their deposit base to debt instruments, especially in the case where the policy rate rises faster than suggested by the implied forward curves in Chart 3, which only shows the central projections.

* The 3-month deposit rate is used in this analysis because it is the retail rate with maturity closest to that of the policy rate.