

Liquidity conditions in the banking system

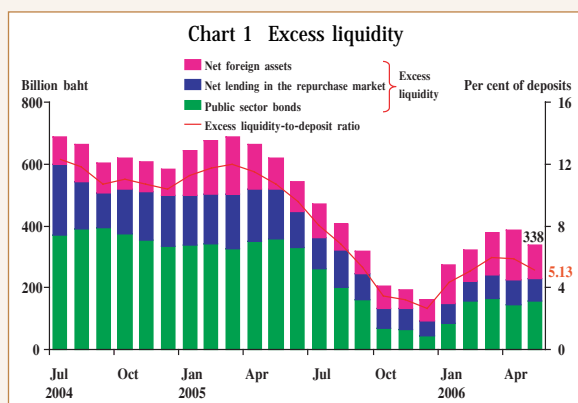
Tightening monetary conditions from the continual rise in the policy rate since August 2004 coupled with intensified competition amongst banks to attract deposits during the past 3-4 months have brought about the question regarding current liquidity conditions in the banking system, in particular whether or not liquidity is already too tight.

Liquidity in the banking system can be analysed from many aspects. Here, we consider 3 indicators: (1) excess liquidity, (2) loan-to-deposit ratio, and (3) money market borrowings.

(1) Excess liquidity

In the July 2004 *Inflation Report*, the definition and estimation methodology of excess liquidity in the financial system were provided. The concept was based primarily on examining the balance sheets of commercial banks and specifying a fixed proportion of disposable liquidity¹ as being excess liquidity. However, in the January 2006 *Report*, the MPC noted that the original concept of excess liquidity might not be suitable especially under dynamic market conditions. The MPC thus asked for a review of the excess liquidity calculation. In particular, the MPC would like to see that the proportion or degree of excess liquidity can vary depending upon the risk-return profile of each asset, which in turn is affected by market conditions. If the risk-adjusted return of an asset increases, that asset would become relatively more attractive as an investment alternative for commercial banks. As a result, commercial banks would be less likely to consider it “excess liquidity”, and thus the proportion or degree of excess liquidity assigned to that asset should decrease.

The Bank of Thailand subsequently adjusted the calculation methodology in line with the MPC’s suggestion. The risk-return profile of each type of liquid assets relative to the risk-return profile of loan extension (the core business of commercial banking) is now used to specify the proportion of disposable liquidity that is considered to be excess liquidity. As a result, such proportions have become more dynamic.



Source: Bank of Thailand

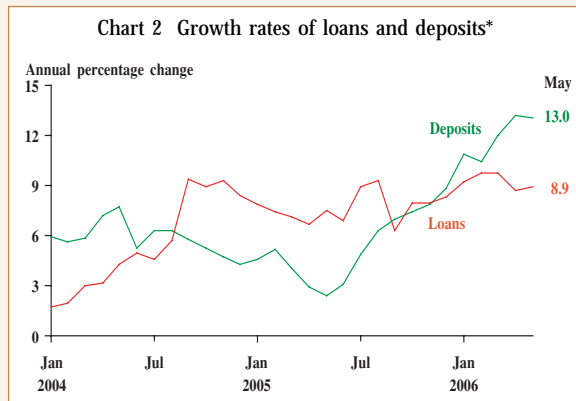
Based on the new concept, excess liquidity in the banking system declined considerably during the latter half of 2005 because the returns on liquid assets (both domestic and foreign assets) adjusted upwards in tandem with domestic and foreign policy rate hikes while the return on bank loans (using MLR or the Minimum Lending Rate) rose to a lesser extent. However, around the beginning of 2006, excess liquidity was back on the upturn, though continuing to stay below the level in the corresponding period of 2005. As of end-May 2006, excess liquidity in the banking system stood at 338 billion baht, amounting to approximately 5 per cent of deposits. The recent build-up of excess liquidity reflected the expansion of the banking system’s asset base, especially in the form of foreign assets due largely to foreign capital inflows.

(2) Loan-to-deposit ratio

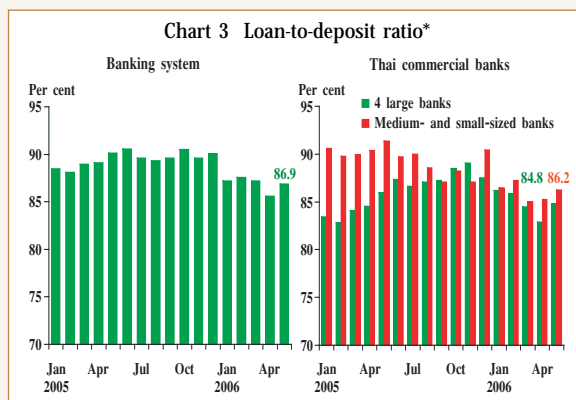
The loan-to-deposit ratio for the banking system as a whole was relatively stable during 2005 but started to decline at the beginning of 2006, suggesting more liquidity in the banking system. This was essentially due to the significant acceleration in deposit growth this year. During the first 5 months of 2006, deposits grew on average by 11.9 per cent year-

¹ Disposable liquidity consists of 1) government and Bank of Thailand bonds, 2) net lending in the repurchase market, and 3) net foreign assets. The corresponding proportions of disposable liquidity originally considered excess are 50, 90 and 40 per cent, respectively.

on-year, more than triple the average growth rate of 3.8 per cent in the corresponding period of last year. To some degree, this was attributable to a surge in deposit rates which helped entice depositors to transfer funds back into the banking system. In addition, capital inflows caused banks' deposits to expand as commercial banks intermediated foreign investors' transactions.



Note: *Include every types of loans and deposits
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reductions in money market investments or increases in money market borrowings were temporary and occurred during periods of intensified competition for deposits (which caused some banks to experience large deposit outflows), periods of high-value fund transfers (which necessitated some banks to prepare liquidity in advance), or periods of anticipated policy rate hikes (which led banks to reduce their investments prior to the MPC meetings in order to invest at a higher interest rate after the meetings). All in all, the reductions in money market investments or increases in money market borrowings were only a reflection of normal liquidity management with temporary tightness from time to time.

In conclusion, liquidity in the banking system remains high as banks' assets have expanded considerably since the beginning of 2006, owing largely to the fact that deposits have been flowing back into the banking system together with the impact from sizeable capital inflows. In quantity terms, this has been reflected in a lower loan-to-deposit ratio. As for the occasional tightness in the money markets, it stems largely from temporary factors and is considered normal in the day-to-day liquidity management of commercial banks. For the banking system as a whole, overall liquidity is still sufficient to accommodate a reasonable degree of loan growth.

There were indeed some differences between the loan-to-deposit ratio of the 4 large banks and that of medium- and small-sized banks. In particular, the loan-to-deposit ratio of the latter group was generally higher than that of the former group. Furthermore, the ratio of medium- and small-sized banks began to decline around mid-2005, whereas the ratio of the 4 large banks started to drift down around the beginning of 2006. These timings coincided with the periods during which each group competed intensely for deposits, thereby suggesting that the banks' deposit mobilisation strategies were quite effective. For the first 5 months of 2006, the ratios for both groups averaged around 85 per cent, indicating ample liquidity in the banking system for reasonable future loan growth.

(3) Money market borrowings

An analysis of commercial banks' money market lending and borrowing behaviours may shed light on the banking system's overall liquidity conditions. For example, if a large commercial bank which has a sizeable deposit base and normally acts as a net lender in the money markets switches its behaviour to borrowing substantially for an extended period of time, then the system's overall liquidity conditions may have become quite tight.

An examination of commercial banks' lending and borrowing activities in various money markets, including the repurchase market, the interbank market and the foreign exchange swap market, reveals no significant changes in their behaviours. Most of the time, recent