

## Reform of the Bank of Thailand's monetary operation framework\*

In the meeting on 17 January 2007, the MPC started using the 1-day repurchase rate as the policy rate in place of the 14-day repurchase rate. This was the first time that the monetary policy operating target has been changed since the Bank of Thailand adopted the Inflation Targeting framework in May 2000.

Such change in the operating target is an essential element in the BOT's monetary operation reform plan, which primarily aims at further enhancing the efficiency and transparency of the BOT's monetary policy implementation as well as promoting the development of the domestic money markets to allow market mechanisms to work fully.

The reform constitutes two main tasks, of which the rationale, objectives, and time frame are described as follows:

### 1. Closure of the BOT repurchase market (BOT RP market)

Currently, financial institutions in Thailand rely primarily on the BOT RP market to manage their short-term liquidity as the transactions are uncomplicated, have relatively low costs, and carry very little risk. However, market conditions as well as various standard market practices have evolved, rendering some current practices in the BOT RP market inappropriate and nonconforming to international standards. Furthermore, these practices do not promote market mechanisms, in particular the pricing mechanism and risk management, which have had adverse impacts on the development of the money and derivative markets. In addition, the cost effectiveness of conducting transactions through the BOT RP market have discouraged market players from trading amongst themselves, thus resulting in the relatively inactive inter-bank markets. Moreover, market players do not see the need to develop financial tools to help them better manage risk and liquidity in the market.

To enable the domestic market to develop smoothly and in line with developments in international financial markets, the BOT has decided to close the BOT RP market and, in preparation for its closure, is undertaking the following steps: (1) Promote alternative channels of liquidity management (2) Enhance the BOT's efficiency in managing liquidity through Bilateral Repurchase transactions in order to ensure an efficient distribution of liquidity across the financial system. The BOT expects to be able to close the BOT RP market by the end of 2007.

### 2. Reform of the monetary policy operation framework

In order to enhance the operational efficiency and ensure consistency with the closure of the BOT RP market as well as with the monetary policy framework that uses an interest rate as an operating target, the BOT has implemented the operation reform comprising three main components as follows:

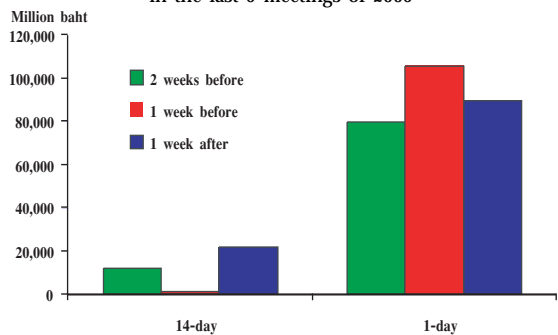
#### 2.1 Switch the monetary policy operating target (the policy rate) from the 14-day repurchase rate to the 1-day repurchase rate

For short-term liquidity management of financial institutions, the liquidity condition in the money market is best reflected in the 1-day repurchase rate, compared with other tenors. This is linked to the amount of deposits held by financial institutions at the BOT (also known as current accounts or CA). The CA holdings relative to the reserve requirements will affect most directly the overnight interest rate as it is the opportunity cost of holding reserves each day. Therefore, in accordance with market mechanism, the interest rate over which the BOT has the most influence is the overnight interest rate. In addition, using the shortest-tenor RP rate as the operating target will reduce distortion in the term structure of short-term money market interest rates as it allows the longer-term interest rates to move according to market expectation on future directions of interest rates.

The usage of the 14-day repurchase rate as the policy rate brings about an unusual fluctuation in shorter-term interest rates when market players have clear expectations as to the future direction of interest rates. For example, during the latter half of 2005, investors, in anticipation of the policy rate hike, avoided investing in the 14-day tenor that would mature after the meeting date, and instead shifted their investments to the 1-day tenor. Once the policy rate was raised, investors then shifted their investments back towards the 14-day tenor (Chart 1). In consequence, overnight interest rates may decline ahead of the meeting in which market players expect a policy rate hike, which may cause confusion in the market.

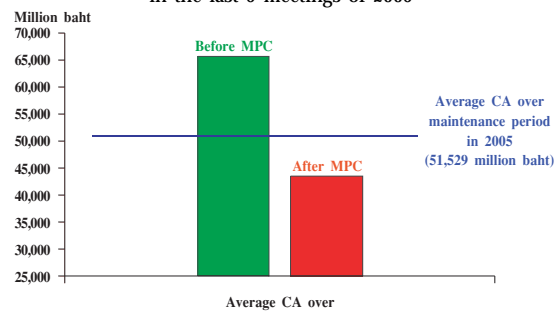
\* Further details are available in the "Reform of the Bank of Thailand's Monetary Operation Framework" article published on the BOT website. (<http://www.bot.or.th> under the topic of "Financial Markets Operations")

Chart 1 Average weekly RP volume around MPC meetings in the last 5 meetings of 2005



Source: Bank of Thailand

Chart 2 Average CA level before and after the MPC meeting during the same reserve maintenance period in the last 5 meetings of 2005



Source: Bank of Thailand

With the aforementioned reasons, the MPC has decided to use the 1-day repurchase rate as the policy rate from 17 January 2007 onwards.

### 2.2 Synchronize reserve maintenance periods with MPC meetings

The reserve maintenance period which is not synchronized with the MPC meeting schedule causes some meetings to be held during reserve maintenance periods which may lead to unnecessary volatility in market interest rates. When an MPC meeting is scheduled during a reserve maintenance period and financial institutions anticipate a change in the policy rate, reserves holdings behaviour over the course of that particular maintenance period before and after the MPC date will differ noticeably, reflecting the financial institutions' attempt to minimize the opportunity cost of holding reserves. This, therefore, results in unwarranted volatility in interest rates. (Chart 2 depicts these behaviours which were apparent during the second half of 2005 when market players strongly expected the MPC to raise the policy rate.)

These behavioral patterns bring about unnecessary complications for market players and cause difficulties in providing the system with the appropriate level of liquidity in aggregate, thus leading to higher risk that the money market interest rates may fluctuate more than warranted. To address the shortcomings, the BOT has changed the reserve maintenance period such that it starts on a Wednesday and ends on a second Tuesday thereafter (totaling 14 days in each period). The new

maintenance periods will no longer overlap with the MPC meetings as the meetings are normally held on a Wednesday with even-numbered weeks apart.

### 2.3 Establish an interest rate corridor of +/- 50 basis points relative to the policy rate to limit interest rate volatility

Currently, financial institutions which are short of liquidity at the end of the day may obtain needed liquidity from the BOT through the End-of-Day Liquidity Facility against eligible securities. The facility offers overnight collateralized lending at the policy rate plus 150 basis points. The standing facility's lending rate can be considered the "ceiling" of overnight market interest rates. On the other hand, if excess liquidity in the market is putting downward pressure on interest rates, there is currently no mechanism in place to moderate potential decline in interest rates. Thus, the range in which market interest rates may vary is relatively wide. This creates risk for market players and reduces the BOT's effectiveness in maintaining short-term interest rates in line with the policy rate.

In order to ensure that market interest rates fluctuate within an acceptable range while, at the same time, encourage market players to adjust liquidity amongst themselves, the BOT has set up a new standing facility called the End-of-Day Liquidity Adjustment Window, through which financial institutions may either borrow from or lend to the BOT in order to adjust their liquidity positions at the end of the day at +/- 50 basis points relative to the policy rate.

In conclusion, the closure of the BOT RP market, which is expected to be completed by the end of 2007, and the reform of the monetary policy operation framework, which has been in effect since 17 January 2007, are important steps in enhancing the effectiveness and transparency of monetary policy implementation as well as in facilitating the continual development of the money markets in Thailand. These would lay a strong foundation for strengthening stability of the financial system and thereby enable it to efficiently withstand rapid changes in the financial markets in the future.