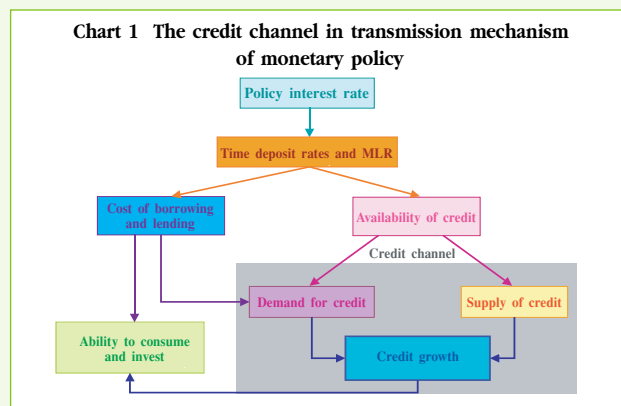


## The credit channel of monetary policy transmission under current circumstances

### 1. How does the credit channel work?

Changes in the policy interest rate induce changes in commercial bank interest rates, which represent the cost of borrowing and lending in the economy. This interest rate movement can be transmitted to the economy through: (1) the demand for credit by households and businesses, and (2) the supply of credit by commercial banks. Both factors will eventually pose a direct impact on credit growth, and the country's ability to consume and invest (Chart 1).

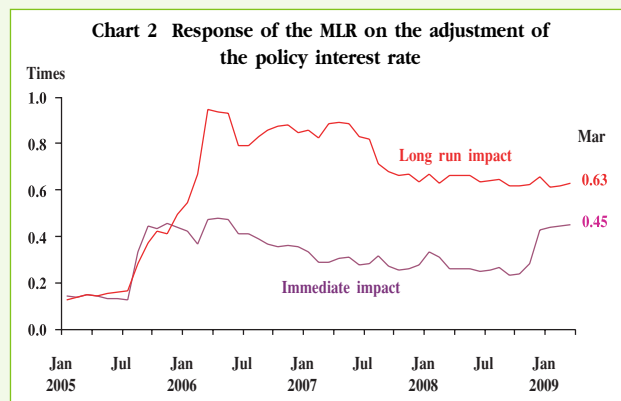
In this light, a study on effectiveness of monetary policy pass-through to the reference lending rate (MLR) indicates that an adjustment of the policy interest rate results in a significant immediate impact on the MLR, particularly from 2008 Q4 (Chart 2), during which monetary policy had been eased aggressively to cushion the impact of the economic slowdown as well as the global financial crisis.



Source: Bank of Thailand

### 2. The credit channel under current circumstances

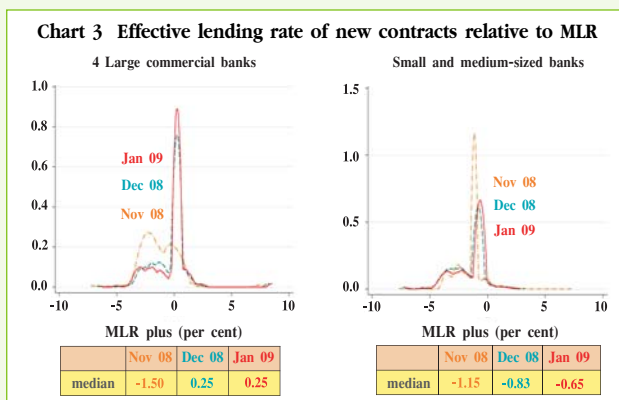
The US financial crisis raised financial system risks and economy uncertainty worldwide, posing a negative impact on the effectiveness of the credit channel in policy transmission. Despite the recent decline in commercial banks' interest rates in response to the policy rate cuts, access to bank credits by borrowers has become more limited under the environment of high uncertainty. At the same time, commercial banks adjusted the risk premium on their lending upwards as well.



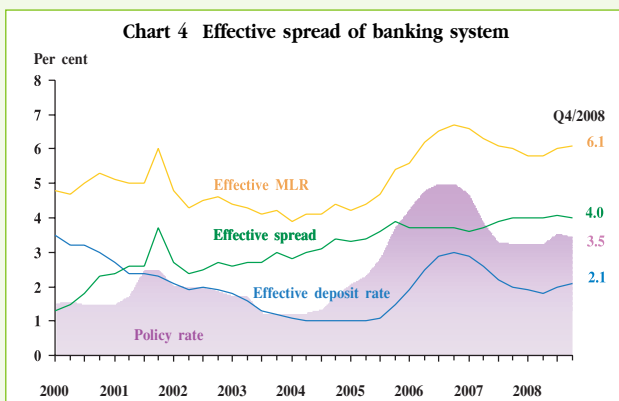
Source: Bank of Thailand

Due to an increasing degree of risk aversion in the banking sector, the effective cost of lending for businesses did not decline in tandem with the reference loan rate. Chart 3 depicts the borrowers' short-term effective lending rate for new loan contracts relative to the reference MLR. On the horizontal axis, zero denotes

the loan interest rate that is equal to the MLR. A value greater than zero towards the right-hand side implies the additional interest rate paid above the MLR, while a sub-zero value refers to an interest rate below the MLR. The vertical axis shows the density of the data or number of contracts at different interest rates relative to the MLR. As can be seen, the median of the loan interest rate (after deducting MLR) in January 2009 increased from that in November and December 2008 for the four largest commercial banks as well as for small and medium-sized banks, reflecting the rising risk premium on loans in the banking system.



Note: For contract value of 20-50 million baht and maturity less than 6 month  
Source: Bank of Thailand



Source: Bank of Thailand

In summary, the higher-risk condition adversely affected the effectiveness of policy transmission via the credit channel, both through price and quantity of loans. As a result, the implementation of monetary policy easing through this channel under current circumstances could be limited. However, the recently launched credit guarantee scheme to help cope with such limitations could help mitigate the problem with monetary policy transmission if the guarantee scheme is effectively implemented with sufficiently wide coverage of businesses.

Moreover, commercial banks are likely to face higher costs in managing risks, such as allowances for bad debt and higher risks on loans, causing them to increase the difference between the effective deposit rates and the effective MLR (i.e., the effective spread). As a result, commercial banks' interest rates could not be reduced by as much as the magnitude of the policy interest rate cuts.

Apart from the impact of higher risks on the price of loans, commercial banks' willingness to lend could also decline. Although banks are currently have ample liquidity, they appear more cautious in their lending due to concerns over the quality of loans that may deteriorate going forward. This phenomenon is also reflected in the results from the Loan Officer Survey for 2008 Q4 as well as the trend for 2009 Q1. This can also be confirmed by the sign of a slowdown in the supply of commercial bank loans that began since 2008 Q4.