

## *Reserve requirement: A potential tool for Thailand*

A number of emerging market economies have been more actively relying on the Reserves Requirement (RR) measure in monetary policy management. Some stated that the measure is a complementary tool to support the main interest rate policy while others have engaged in such measures for a macro-prudential purpose to keep credit expansion in check. The necessity and effectiveness of the implementation of the RR measure depend on various factors such as the financial landscape and its development as well as the monetary policy framework in each economy. In an economy with a high level of excess liquidity like Thailand, RR is likely to be ineffective even when implemented along with the interest rate policy.

### **Objectives of the RR measure**

1. A micro-prudential tool to reduce liquidity risk in the banking system and help preserve depositors' confidence. However, prudential regulation and supervision on bank liquidity such as the liquidity ratio that have been improved and strengthened over time should downplay the role of the RR measure for this purpose.

2. A monetary policy tool to oversee money supply and a macro-prudential tool to control credit expansion, as adopted by China and India. Here, RR works through the money multiplier mechanism via the banking system's balance sheet, and also affects the interest rate spread<sup>1/</sup> in some cases.

3. A complementary tool to manage and stabilize liquidity in the economy and sustain the functioning of the banking system during crisis. The use of the RR measure under this circumstance should not be regarded as a signal of monetary policy. Take Malaysia for example. The central bank reduced the RR ratio to inject additional liquidity to the commercial banking system during the financial crisis, and subsequently raised the RR ratio when the liquidity condition became normalized. In their conducts, the central bank issued a clear and separate press statement from the MPC statement, indicating that the action was not a part of the monetary policy tightening process.

### **Conditions for imposing the RR measure**

**1. Monetary policy framework:** the RR measure produces a direct impact on money supply and credit expansion, which makes the measure more appropriate for economies under the monetary targeting (China) and credit targeting (India) frameworks than those under the inflation targeting (IT) regime. The reason is that the IT framework focuses on managing inflation expectation which relies mainly on the policy interest rate. The term structure featured in the interest rate reflects a path of future monetary policy that will result in economic adjustments as well as anchors inflation expectation in the long-run within the target range. This term structure property does not exist in the case of the RR measure, limiting its role as a monetary policy tool. As a result, most IT countries, including Thailand, have designated the RR measure mainly to oversee liquidity risk in the commercial banking system.

**2. Depth of financial instrument and market development:** In a developed financial market, the RR measure can be implemented as a complementary tool to the conventional instrument when the monetary policy transmission mechanism is clogged as in the case of the recent financial crisis. In addition, some IT countries may reduce the RR ratios to provide more liquidity to the market along with reducing the policy interest rates in order to stimulate economic activities. In the case of a premature financial market in which the effectiveness of financial instruments in absorbing liquidity is limited such as China, the RR measure becomes the main instrument for liquidity adjustment and monetary policy management.

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<sup>1/</sup> At a very high level of excess liquidity, raising the reserve requirement ratio will increase the cost of deposits and banks will have to adjust the interest rate spread, possibly by lowering the deposit rate. Such a change in the deposit rate will conflict with the policy stance and interfere with monetary policy signal, thus weakening the effectiveness of monetary policy. Moreover, this will encourage depositors to turn to invest in higher risk assets and induce additional financial imbalances. To avoid this distortion, many central banks therefore pay interest for required reserves.

**3. Level of excess liquidity in the system:** In the case of a high level of excess liquidity, raising the RR ratio can not effectively impact commercial banks' lending behavior because (1) commercial banks can find alternative sources of inexpensive funding and (2) the cost of additional RR to commercial banks will only be a small fraction of the total value of their balance sheets during a period of a high level of excess liquidity, thus reducing the need to adjust their interest rate spreads.

**4. Commercial banking landscape:** Under intense competition, commercial banks are unlikely to pass the entire cost of RR on depositors and borrowers. In addition, in a non bank-based financial system, the RR measure is effective only in the short-run since borrowers can switch to other sources of financing, i.e. disintermediation. As a result, this setting is likely to create more uncertainty to the effectiveness of the RR measure in terms of liquidity adjustments and banks' capacity to lend.

**5. Policy Dilemma:** During the recovery from the recent global financial crisis, emerging markets have witnessed tremendous and sustained capital inflows. Meanwhile, inflation pressures have risen, resulting in a policy dilemma as the increase in the policy interest rate to combat inflation will produce a side effect by attracting more capitals and hence more burden for policy makers to react. Under such a circumstance, many countries in Latin America such as Brazil, Peru, and Colombia, including Turkey instead have relied more on the RR ratios to restrain excessive credit expansion.

#### The potential to implement the RR measure for Thailand

The effectiveness of the RR measure especially on overseeing credit expansion remains uncertain and depends upon various conditions as previously stated. Under the current economic and financial conditions in Thailand, the active use of the RR measure together with the policy interest rate will not be effective neither for managing liquidity, controlling credit expansion, nor curbing inflation expectation due to the following reasons:

**1. Under the IT framework, the RR measure has limitations for being an effective monetary policy instrument** due to its inability to manage inflation expectation mentioned above. Besides, Thailand has not experienced any limitation in absorbing excess liquidity through existing financial instruments.

**2. Excess liquidity in the commercial banking system has been high:** liquid assets in the commercial banking system are roughly 4.4 times<sup>2/</sup> the size required by law. Consequently, increasing the RR ratio along with the policy interest rate should be an ineffective measure to curtail credit expansion since commercial banks can be compensated by other sources of funding with slightly higher cost. Moreover, the required increase in the RR ratio to absorb liquidity is likely to be very large.

**3. The existing financial landscape** where specialized financial institutions are not under the same supervisory standards as commercial banks can significantly reduce the effectiveness of the RR measure, especially when the government's lending policy differs from that of the BOT. Despite commercial banks' large market share in the financial system and low market competition, commercial banks are not under pressure to adjust their lending behaviours as well as interest rates, given the currently high level of excess liquidity.

**4. The linkage between the interest rate differential and capital inflows is weak in the case of Thailand** with other factors such as the outlook for economic growth and risk sentiment in the global financial market playing a more vital role in influencing flows of capital. Accordingly, raising the policy interest rate to curb inflation expectation should not significantly attract additional inflows, thereby lowering the need to impose the RR measure in order to avoid the policy dilemma as in other countries.

For Thailand, using the RR measure to influence credit growth will not be effective under the high level of excess liquidity as the cost of the RR imposition to commercial banks is considerably low<sup>3/</sup>. The implementation of the measure under the current condition, on the other hand, will raise questions regarding the policy formulation and eventually deteriorate market confidence as well as the credibility of monetary policy as a whole.

<sup>2/</sup> At the end of January 2011, liquid assets of the commercial banking system stood at 2.1 trillion baht, or 4.4 times the size of required liquid assets of 47.0 billion baht. (Source: Liquid Assets of Commercial Banks, the Bank of Thailand)

<sup>3/</sup> A one percent increase of the RR ratio will raise the interest rate cost of commercial banks by only 0.02 percent (the opportunity cost that banks could have invested the required reserves in other assets such as BOT bond)