

BOT could cut policy rate again if circumstances call for it

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The sharp economic slowdown in industrial countries, during end-2008, which spread to economies around the globe due to the financial crisis, marked the beginning of the downward interest rate cycle. On 3 December 2008, the MPC thus made a historical policy interest rate cut of 100 basis points, from 3.75 to 2.75 percent. The policy rate was then reduced 3 more times by 75, 50 and 25 basis points in January, February and April 2009, respectively- to help support economic recovery.

Overall, the policy rate was cut by a total of 250 basis points to stand at 1.25 percent annum. The adjustment was front-loaded due to large downside risks stemming from external and domestic factors. However, once downside risks subsided, the size of policy interest rate cuts also declined. In its latest meeting on 20 May 2009, the MPC decided to keep the policy rate at 1.25 percent , an unexpected move to many. This was because extreme downside risks had diminished, with some positive signs showing. These included signs of stabilization in international financial markets and positive outcomes from monetary and fiscal policies conducted in many countries. Moreover, some Thai economic indicators showed a more moderate contraction, signaling that the economy might have bottomed out, while the impetus from fiscal measures became more evident.

The MPC also thought the current policy interest rate was low and would continue to accommodate the process of economic recovery, especially once industrial economies started to recover.

How much the real economy will benefit from the loose monetary policy stance now depends on how much banks are able to pass-on the policy rate cuts to lending rates.

This leads us to another important issue, the effectiveness of the monetary policy transmission mechanism. During the past few months, banks have been reducing lending and deposit rates following the policy interest rate cut. Deposit rates declined by 1.70 percent, while lending rates fell by only 1.19 percent, compared to the 2.50 percent policy rate cut, reflecting that banks still have room to reduce their lending rates.

It is understandable, however, that weak economic conditions could bring about higher operational risks for the corporate sector, leading banks to charge higher risk premiums, as reflected in the interest rate spread.

Furthermore, banks had tightened their lending standards, resulting in lower credit extension, which lessened the effectiveness of the monetary policy, a problem the central bank has to disentangle. Last of all, in every meeting the MPC evaluates uncertainties, both from external and domestic factors, hence its decision to maintain the policy rate at 1.25 percent should not be interpreted as the end of the downward interest rate cycle.

For should the world economy worsen or political unrests become an issue again, given that there is no risk of breaching the inflation target, the MPC still has room to cut the policy rate.

(The views expressed are the author's own.)

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