

Guru Speak : Understanding Liquidity Conditions during the Financial Crisis

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The recent US-dollar liquidity crunch in global financial markets raised concerns over contagion into liquidity conditions in the domestic market. As a result, questions have arisen as to what are the most reliable indicators of liquidity.

Liquidity can be measured in three aspects. The widest measure that of money market, is relatively tricky as funds can be parked in various types of instruments. Most market participants focus on movements in short term interest rates, such as interbank rates, to gauge liquidity conditions, As seen during the recent crisis, the hike in US-dollar interest rates indicated a shortage of dollar liquidity in the Thai market Baht-denominated interest rates, however, were undisturbed and remained well anchored around the policy rate, reflecting ample baht liquidity, having so far been shielded from the external crisis.

A narrower but more accurate measure of liquidity is that of the banking system, as measured by loan-to-deposit ratios of commercial banks. A high L/D ratio indicates a high proportion of credit relative to the stock of deposits the main source of banks loan able funds-and hence tighter liquidity conditions. In Thailand, this ratio trended upwards for some time, leading to rising concerns that the ongoing crisis could exacerbate already tight liquidity conditions.

In the past year, the relatively low rate of interest (especially in real terms) partly led to the continued decline in deposit growth as depositors switched to higher yield instruments such as stocks and bonds. At the same time, higher inflation drove up demand for loans, as corporations needed to match their rising costs. Consequently, the banking sector's L/D ratio climbed to more than 90 per cent in recent months.

Going forward, the liquidity in the domestic banking system could tighten as a result of credit switching from foreign to domestic sources, given tighter liquidity in international financial markets and increasing in periods ahead, demand for new credit would eventually decline and cushion the liquidity tightening.

At least thus far, the US crisis has posed only a second-round impact on domestic liquidity conditions, especially at the firm level-the third measure. The expected global slowdown

is likely to Heighten risks of the private sector, particularly small firms, harming banks' credit quality. The latest loan-officer survey by the Bank of Thailand pointed out that credit requirement by banks had begun to tighten, particularly those for small and medium sized enterprises. Moreover firms' financing costs have begun to rise in tandem with the increasing risk premium. These changes in bank's lending decisions, as a result, have created a perception of tighter liquidity in the banking system.

It should be noted that these seemingly tight conditions were the sole result of a decline in banks' willingness, and not their ability, to lend as banks still have excess liquidity invested short term in the money market. As a result, a relaxation of liquidity conditions will depend on the willingness of both borrowers and lenders to bear risks, which is beyond the control of supervisor authorities.

Source: The Nation