

Monetary-Policy Transmission Hinges on Risk Premium

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The sting of globalisation was felt once again as the sub-prime crisis turned into a global economic slowdown. Conventional and unconventional measures have been applied in many countries to revive financial markets and the real economy. During this hard time, monetary policy has been one of the main tools utilised in coping with both financial and economic problems.

Traditionally, monetary policy works via changes in money-market interest rates and relies on different channels of economic activity to pass these changes on to private agents. For a small and developing economy like Thailand, credit is the major transmission channel for monetary policy. Changes in money-market rates typically lead to changes in banks' deposit and lending rates, as banks, the main players in the money market, deposit excess funds and borrow when they are short of funds to lend out at a rate short of funds to lend out at a rate determined directly by the policy investors via the change in bank retail rates with a lag of approximately four to six weeks.

Recently, however, the transmission of monetary policy via the credit channel has been somewhat impaired. Specifically, bank retail rates have not responded fully to changes in the policy rate. One simple explanation is that in an environment of economic uncertainty and rising risk premiums, banks need to exercise caution in their lending. As a result, the quantity of new loans may be curtailed through tighter lending standards while the cost of borrowing remains high to compensate for higher risks.

The effect of policy-rate changes is transmitted almost instantaneously, however, into money-market rates, which includes bond yields. A reduction in the government's benchmark yield curve in response to a policy-rate cut should lead to lower borrowing costs for new government bond issues. This reduction in the benchmark yield curve, upon which corporate bond rates are based, should lower the cost of corporate issues. In an environment of higher risk and uncertainty, however, the risk premium for such borrowing could rise in tandem.

This raises the question of whether monetary policy is really effective under these circumstances. The answer is both yes and no. Policy interest-rate reductions are not fully and instantaneously transmitted to bank retail rates, and banks may exercise caution by tightening lending standards. Transmission into money markets may be instantaneous, but whether this is reflected in corporate borrowing rates, which include a risk premium, varies.

In retrospect, the recent uncertainty of policy effectiveness (even amidst the latest oil crisis) seems to originate mainly from external factors that an authority in a small developing country has limited power to control. It is important to note that globalisation, besides bringing economies closer together through increased trade and financial linkages, can also alter the transmission mechanism of monetary policy. As a result, unconventional policy tools and approaches are called for in coping with this ever-changing dynamic in order to maintain the macroeconomic stabilising ability of monetary policy going forward.

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Source: The Nation