

Reform of the Bank of Thailand's Monetary Operation Framework

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November 2006

Over the past few years, the Thai financial market has progressively developed and now includes a more diverse group of investors and a greater variety of financial products. In addition, market liquidity has also markedly improved. The development of financial market has been a major force in strengthening the stability of the overall financial system and in increasing the efficacy of the monetary policy transmission mechanism under the inflation targeting regime.

To further enhance the efficiency and transparency of the Bank of Thailand's monetary policy implementation as well as to facilitate the continued development of the financial market, the Bank of Thailand (BOT) is thus reforming its monetary policy operation framework. The BOT envisages the reform process to be wholly completed within 2007.

This paper aims to describe the reform plan in details covering the following issues:

- 1) Reasons and motivations behind the reform
- 2) Reform objectives
- 3) Details of reform measures
- 4) Reform time frame
- 5) Conclusion

Reasons and motivations behind the reform

The structure of the BOT-operated repurchase market and the current operation framework do not effectively facilitate either the development of the financial market or the transparency of the monetary policy operations. The following section discusses the two main reasons for the reform.

- **Characteristics of the BOT-operated repurchase market (BOT RP)**

Currently, financial institutions in Thailand rely primarily on the BOT RP market to manage their short-term liquidity as the transactions are uncomplicated, have relatively low costs, and carry very little risk. These stem from the fact that the BOT acts as the central counterparty to all transactions in the market. In the past, this market setup had worked well in responding to market participants' needs under both normal and extraordinary market conditions. It was also in line with the prevailing stage of market and financial system developments at the time. However, market conditions as well as various standard market practices have evolved rapidly rendering some current practices in the BOT RP market inappropriate and nonconforming to international standards. For example, there are no transference of collateral ownership thus making it impossible to mobilise the collateral in subsequent transactions, and no revaluation of

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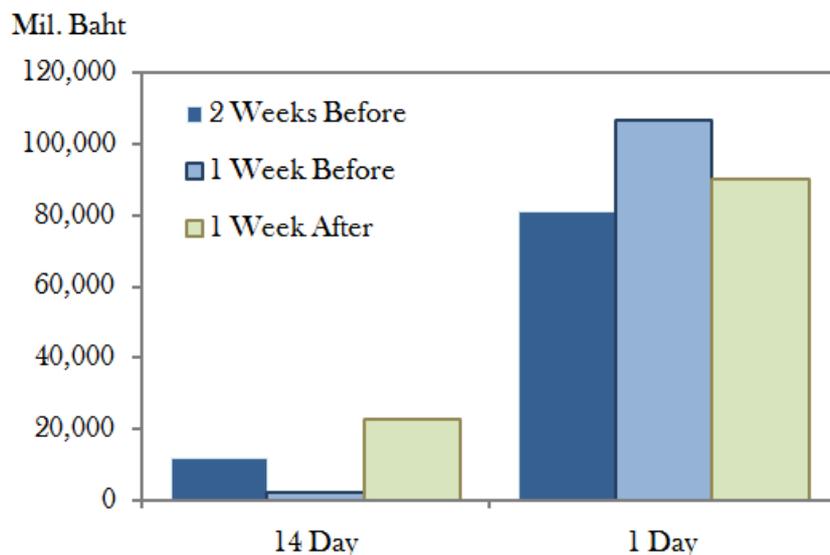
collaterals at market prices during the life of the repo contracts. These distort some important market mechanism such as the pricing mechanism and risk management. The distortions have had adverse impacts on the development of the money and derivative markets. The simplicity and cost effectiveness of conducting transactions through the BOT RP market have discouraged market players from trading amongst themselves, thus resulting in the relatively inactive private repurchase market and interbank deposit market. Moreover, market players do not see the need to develop financial tools to help them better manage risk and liquidity in the market.

- **Limitations of the current monetary policy operation framework**

a) For short-term liquidity management of financial institutions, the liquidity condition in the money market is best reflected in the 1-day RP rate, compared with other tenors. This is linked to the amount of deposits held by financial institutions at the BOT (also known as current accounts or CA). The CA holdings relative to the reserve requirements will affect most directly the overnight interest rate as this is the opportunity cost of holding reserves each day. Therefore, in accordance with market mechanism, the interest rate over which the BOT has the most influence is the overnight interest rate. In addition, using the 1-day RP rate as the operating target will reduce distortion in the term structure of short-term money market interest rates as it allows the longer-term interest rates to move according to market expectations on future directions of interest rates. It is with this reasoning that many central banks have chosen the overnight interest rates as their operating targets.

The usage of the 14-day RP rate as the policy rate has its limitation when market players have clear expectations as to the future direction of interest rates. For example, if market players expect the Monetary Policy Committee (MPC) to raise the policy rate in its next meeting, they will alter their investment behaviours such that they will avoid investing at terms that will mature after the meeting date. This can be seen in the latter half of 2005 when investors shifted their investments from the 14-day tenor to the 1-day tenor in anticipation of the policy rate hike. Once the policy rate has been raised, investors will shift their investments back towards the 14-day tenor (Figure 1).

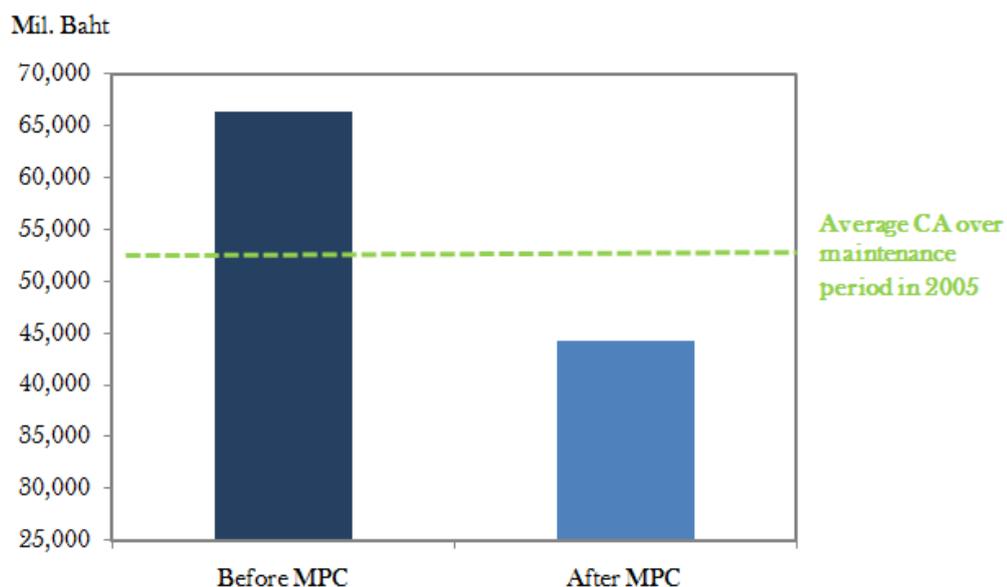
Figure1: Average weekly RP volume around MPC meetings in the last 5 meetings of 2005



The above behaviour is a result of the BOT having to maintain the 14-day RP rate at the prevailing policy level rather than allowing it to move with market expectations. In consequence, overnight interest rates may decline ahead of the meeting as investors shift their investments towards the shorter- end. The fall in short-term interest rates ahead of the MPC meeting, in which market players expect a policy rate hike may cause uncertainty or confusion in the market. This was one of the reasons that some central banks, such as the Bank of England and the European Central Bank, have reformed their monetary policy operation frameworks.

b) The current reserve maintenance period is not synchronized with the MPC meeting schedule. Consequently, some meetings are held during reserve maintenance periods which may lead to unnecessary volatility in market interest rates. When an MPC meeting is scheduled during a reserve maintenance period and financial institutions anticipate a change in the policy rate, reserves holdings behaviours over the course of that particular maintenance period before and after the MPC date will differ noticeably, resulting in unwarranted volatility in interest rates. For example, if financial institutions strongly anticipate the MPC to tighten the policy rate in the middle of a particular reserve maintenance period, the opportunity cost of holding reserves after the MPC date would increase as reserves are not remunerated. To minimize their costs of holding reserves during that particular period while ensuring that they meet the average required reserves, they will thus build up CA balances in the days prior to the MPC meeting and run down the holdings in the days afterwards. Figure 2 depicts this behaviour which was apparent during the second half of 2005 when market players strongly expected the MPC to raise the policy rate.

Figure 2: Average CA level before and after the MPC meeting during the same reserve maintenance period in the last 5 meetings of 2005



Furthermore, the current reserve maintenance period which is fixed on exact dates of each month² results in uneven number of days in each maintenance period. In addition, the last day of the maintenance period, during which financial institutions normally adjust the bulk of their CA positions, may fall on either a Friday or a Monday, which could exacerbate any imbalances in the CA holdings as these are accumulated over the weekends, and thus necessitating an unusually large adjustment to bring the CA balances to the desired level on the last working day of the reserve maintenance period. These behavioural patterns coupled with an MPC meeting during a reserve maintenance period result in unnecessary complications for market players and cause difficulties in providing the system with the appropriate level of liquidity in aggregate, thus leading to higher risk that the money market interest rates may fluctuate more than warranted.

c) There are limitations in effectively containing interest rate volatilities. Currently, financial institutions which are short of liquidity at the end of the day may obtain needed liquidity from the BOT through the End-of-Day Liquidity Facility against eligible securities. The facility offers overnight collateralized lending at the policy rate plus 150 basis points. This standing facility's lending rate can be considered the "ceiling" of overnight market interest rates as financial institutions could always obtain needed liquidity from the BOT at the specified rate and would therefore have no incentives to borrow in the market at above this rate. On the other hand, if excess liquidity in the market is putting downward pressure on interest rates, there is currently no mechanism in place to moderate potential decline in interest rates.

By imposing a relatively high ceiling on interest rates when the BOT does not have in place any mechanism to alleviate downward pressure on interest rates, the range in which market interest rates may vary is thus relatively wide. This creates risk for market players and reduces the BOT's effectiveness in maintaining short-term interest rates in line with the policy rate. This risk will become more pronounced when the BOT RP market closes down in the future and liquidity adjustment amongst market participants are still not yet efficient.

Reform objectives

To address the aforementioned shortcomings, the BOT has designed a new monetary policy operation framework in pursuit of the two main objectives as follows:

1) Closure of the BOT RP market to enable the domestic money market to develop smoothly and in line with developments in other markets such as the bond market.

2) Have in place a more transparent and more market-based operation framework that implements the MPC's interest rate decisions more effectively and is consistent with the closure of the BOT RP market.

² Currently, commercial banks are required to maintain reserves on average over a fortnightly period from 8th to 22nd and 23rd to 7th of each month, using the previous period's average level of commercial banks' deposits/liabilities as the base.

Details of reform measures

In order to achieve the reform objectives mentioned above, the BOT has set out the essential components of the reform measures as follows:

- **Closure of the BOT RP market**

The following steps are needed to be undertaken to ensure smooth closure of the BOT RP market:

1) Promote alternative channels of liquidity management for financial institutions including the Financial Institutions Development Fund (FIDF). For example, the private repo market and the interbank deposit market.

2) Enhance the BOT's efficiency in managing liquidity through Bilateral Repurchase transactions in order to ensure an efficient distribution of liquidity across the financial system.

The timing of the closure of the BOT RP depends upon many factors including readiness of market participants to manage their liquidity without relying on the BOT RP market as well as the BOT's preparedness to utilize monetary instruments other than the BOT RP. Taking all these into considerations, the BOT expects to be able to close the BOT RP market by the end of next year.

- **Reform of the monetary policy operation framework**

In reforming the monetary policy operation framework to enhance operational efficiency, support the closure of the BOT RP market, and be consistent with the monetary policy regime which uses an interest rate as an operating target, the BOT will implement the operation reform which comprises three main elements as follows:

1) Switch the monetary policy operating target (the policy rate) from the 14-day RP rate to the 1-day RP rate. In conducting open market operations in the morning bilateral repurchase round, The BOT will focus on operations with a one day maturity which will be conducted at the policy rate. If the BOT engages in other longer-term operations, they will be conducted via variable-rate tenders, thus allowing term-interest rates to better reflect market conditions and expectations. However, to ensure that no fixed-rate operations span the MPC meetings, the BOT will avoid conducting 1-day bilateral repurchase operations on the day of the meeting as the MPC's interest rate decisions are usually announced in the afternoon.

2) Synchronize reserve maintenance periods with MPC dates

a) Change the reserve maintenance period from being fixed on exact dates of the month to being fixed on days of the week instead. The reserve maintenance period will start on a Wednesday and end on a second Tuesday thereafter totaling 14 days in each period. The new maintenance periods will no longer overlap with the MPC dates as the meetings are normally held on a Wednesday with even-numbered weeks apart.

b) Employ a uniform reserve maintenance period across all financial institutions that are required to hold reserves. (Currently, finance companies and credit foncier companies have shorter reserve maintenance periods.)

3) Establish an interest rate corridor of +/- 50 basis points relative to the policy rate to limit interest rate volatility

The BOT will establish a new standing facility called the End-of-Day Liquidity Adjustment Window through which financial institutions may either borrow from or lend to the BOT in order to adjust their liquidity positions at the end of the day.

In a case where financial institutions need to obtain liquidity, the procedure is basically the same as the existing end-of-day liquidity facility, that is, through reverse repo transactions. However, the rate charged will be less penal, at 50 basis points above the policy rate³. As for financial institutions with excess reserves, they will be able to lend their surpluses to the BOT at 50 basis points below the policy rate in return for a BOT debt instrument⁴. All transactions are for an overnight tenor with same-day settlement. The standing facility is open every working day from 16.30 – 17.30 and is available to all financial institutions holding CA deposits at the BOT.

In determining the width of the interest rate corridor at +/- 50 basis points, the BOT has taken into consideration the following factors:

1) Having too wide a corridor would entail a risk that market interest rates may be very volatile, while

2) Having too narrow a corridor would reduce the incentives for market players to trade amongst themselves as they may just as easily transact with the BOT directly. This may discourage effective liquidity management and therefore hinder market development.

Balancing these considerations and taking into account past behaviour of market players, the BOT judges that the corridor should be established at +/- 50 basis points relative to the policy rate. The corridor is deemed to be sufficiently wide to encourage market players to adjust liquidity amongst themselves and thus have recourse to the BOT's standing facility only when necessary. At the same time, the corridor is also narrow enough to ensure that market interest rates will fluctuate within an acceptable range, and should financial institutions find a need for the facility, especially during the transition period to the new framework where liquidity management in the market may not be quite as efficient yet, it would not significantly affect their funding costs.

Reform time frame

The BOT plans to implement the new monetary policy operation framework on the first MPC meeting date of next year. The BOT RP market is, however, expected to cease operating around the end of 2007. Further details on these arrangements will be announced at a later date.

³ The interest rate charged on overnight borrowings resulting from intraday liquidity spillovers (ILF overnight) which is equal to the existing end-of-day liquidity facility rate will also be adjusted downward.

⁴ The BOT debt instrument can be counted towards meeting the reserves requirements as part of the unencumbered eligible securities.

Conclusion

The closure of the BOT RP market is an important step in the development of the financial market. It will allow market mechanisms to work fully, which would increase financial institutions' effectiveness in managing liquidity as well as enhance transparency of the BOT's monetary policy operation framework. In preparation for the changes and the new environment, the BOT has been reforming its monetary instruments in managing the liquidity so as to be consistent with the use of the interest rate as the operating target. The BOT envisages that this reform will lead to the monetary policy operation framework that is more efficient and more transparent whilst simultaneously promote further development of the Thai financial market. These should help lay a strong foundation for strengthening stability of the financial system and enable it to efficiently withstand rapid changes in the financial markets in the future.