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# Monetary policy and the transmission mechanism in Thailand

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## Abstract

This paper studies the monetary transmission mechanism in Thailand. It examines the degree of pass-through from money market rates to retail rates, attempts to quantify the lags associated with monetary policy shocks, and investigates the channels through which these shocks are propagated. The empirical results point to a transmission mechanism in which investment is particularly sensitive to monetary shocks and banks act as an important conduit for monetary policy to real activity. They also suggest, however, that problems in the corporate and banking sectors may have undermined the monetary transmission mechanism over the last few years.

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## 1. Introduction

Understanding the transmission mechanism of monetary policy—especially the time lag involved between a policy change and its impact on inflation and output—is key to the successful conduct of policy. This paper attempts to improve our knowledge in this respect by addressing one key question: What are the stylized facts concerning the transmission of monetary policy in Thailand? With the emphasis on identifying the empirical regularities associated with monetary policy shocks in Thailand, the analysis carried out in this paper are of a positive rather than normative nature. We focus on what is rather than what should be.

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How can monetary authorities influence the level of activity in the economy? There are a number of different but related channels through which changes in the stance of monetary policy affect the real economy. They include the traditional interest rate channel, the credit channel, the exchange rate channel, and the asset price channel.<sup>1</sup> We will discuss each of these in turn and attempt to gauge their relative importance in Thailand. While the impact of monetary policy on the real economy and prices are determined by the monetary transmission mechanism taken as a whole, and by their respective importance, the regulatory framework of banking, as well as banking practices specific to each country and the structure of assets and liabilities also play a role in influencing the reactions of non-financial agents to interest rate changes. In addition, the degree of liquidity constraints related to bank practices influences the extent to which household and business expenditures are affected by monetary policy. For example, ceilings on indebtedness and large down-payment requirements hamper the ability of consumers to substitute between present and future expenditure, limiting the impact of changes in monetary policy on consumption. This constraint has been significant in Thailand as the consumer credit business has not really been developed until recently and, to a large extent, the desire by households to raise their spending when interest rates fall has been limited by their current earnings.

Our strategy for analyzing the transmission mechanism in Thailand is to first obtain a good quantitative assessment of the dynamic consequences of a change in the policy controlled interest rate on the main macroeconomic variables. Armed with these estimates, one could then gauge the overall impact of policy and attempt to disentangle the channels through which it takes place. In doing so, this paper relies heavily on the use of vector autoregressions (VARs). These are dynamic systems of equations that examine the interrelationships between economic variables, imposing minimal assumptions about the underlying structure of the economy, which—given the limited knowledge and lack of consensus about the transmission mechanism in Thailand—is a distinct advantage. VARs have also been used extensively to study monetary transmission in other countries so we can readily compare our results for Thailand with the international evidence.<sup>2</sup>

The paper is organized as follows. We begin by examining the degree of pass-through from market interest rates to banks' retail rates in [Section 2](#), which—given Thailand's heavy reliance on bank lending—constitutes a key element of the transmission mechanism. Results from our VAR analysis are then presented in [Section 3](#). We start by estimating a simplified basic model, which is then extended to examine the sensitivity of different components of aggregate demand—private consumption, investment, exports, and imports—to monetary shocks. Next, we analyze the main channels through which monetary policy is transmitted to the real economy by comparing the output response to monetary shocks when successive channels of transmission are blocked off in the VAR, to the baseline response when the channel of interest is allowed to operate. Differences in the path of output gives an indication of the importance of that particular channel in acting as a conduit for monetary policy. Finally, we present a summary VAR that we feel captures the key elements of the transmission mechanism in Thailand. [Section 4](#) concludes and some technical details are collected in an appendix.

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<sup>1</sup> A concise overview of the channels of monetary transmission is given by Mishkin (1996).

<sup>2</sup> A brief technical summary of the VAR methodology is presented in [Appendix A](#).

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