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Thai monetary policy transmission in an inflation targeting era

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Abstract

A critical issue involved with the transmission of monetary policy is the degree and speed at which changes in the official policy rate are transmitted to other rates faced by firms and households. The paper explores changing financial environment in Thailand after inflation targeting has adopted. Furthermore, the empirical analyses are provided to investigate the long-run relationship and the degree of pass-through between the policy rate and the various financial market interest rates in Thailand. It is found that there exist co-movements between 14-day repurchase rate and the financial market rates in the long-run, except for the finance company lending rate. The paper also shows that the transmission of monetary policy through the interest rate channel has become weak. Nonetheless, the credit channel through the commercial bank lending is still a valid monetary transmission mechanism of Thailand. It is worth noting that there is a decrease in the degree of disintermediation as well as an increase in the roles of other sources of fund.

JEL classification : E42; E52; E58

Keywords: Transmission of monetary policy; Interest rate pass-through; Asymmetric adjustment

1. Introduction

It is commonly known that monetary authorities around the globe alter their policy instruments at their disposal in an attempt to achieve their ultimate objectives such as price stability and sustainable economic growth. These processes involve the transmission mechanism of monetary policy. Most central banks normally use a short-term interest rate as their main instrument of monetary policy. There is a presumption that the official rate changes will influence the other short-term rates set by other banks and financial institutions; as changes in the official

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rate are the first step in the transmission of monetary policy. Hence, consumption and investment decisions by households and firms will be led by changes in interest rates charged by banks and other financial institutions. Therefore, effect of monetary policy will be substantial, if official rate changes could be completely passed-through to other interest rates in the market over a reasonably short period of time. In other words, a critical issue involved with the transmission of monetary policy is the degree and speed at which changes in the official policy rate are transmitted to other rates faced by firms and households. In practice, the transmission mechanism of monetary policy is usually sluggish and incomplete in the short run; therefore, changes in the policy rate induced by monetary policy are transmitted to other interest rates with lag. Consequently, interest rate differentials exist in the economy.

This paper aims at answering these following four questions: (1) What have happened in Thailand in term of financial environment after adopting inflation targeting? (2) To what extent are changes in the 14-day repurchase rate passed-through to various retail deposit and lending rates? (3) What are speeds at which changes in the policy rate transmitted to deposit and lending rates? And (4) How does monetary policy transmit its effect through credit and interest rate channels after inflation targeting has been adopted?

This paper is structured as follows. Section 2 describes details on background of monetary policy in Thailand. Section 3 shows empirical testing of the relationship between monetary policy and interest rates, degree of pass-through and asymmetric adjustment as well. Section 4 employs vector-autoregression models to estimate monetary policy transmission in Thailand. Section 5 reflects our conclusion remark.

2. Background on monetary policy in Thailand

2.1. Monetary policy framework

The monetary policy framework in Thailand can be divided into three periods as follows. The first monetary policy regime was the pegged exchange rate. This regime had been adopted after the Second World War. However, when a greater degree of international capital flow has been allowed; a monetary policy regime with fixed exchange rate became one factor that led the country to an excessive external borrowing and financial instability afterwards. After letting the baht float on the July 2, 1997; the Bank of Thailand had initially maintained high short-term interest rates as one mechanism that aimed at preventing the baht from substantial depreciation. Simultaneously, the Bank of Thailand started targeting monetary aggregates within a financial programming approach to ensure macroeconomic consistency and to achieve price stability and sustainable economic growth as well. Therefore, daily liquidity management was pursued in order to prevent excessive volatility interest rate and to ensure that there was enough liquidity in the Thai financial system.

Later on, when Thailand had exited the IMF program; the Bank of Thailand formally adopted inflation targeting in May 2000. The change in monetary policy framework resulted partly from the fact that the Bank found less stable relationship between money supply and output growth. Moreover, the Bank also reappraised its domestic and external environment and found that monetary targeting would not appropriate for the Thai economy anymore. Under the third regime of monetary framework, an inflation targeting, the Bank implements its monetary policy by influencing short-term money market rates through the selected key policy rate.

The Bank of Thailand currently uses the 14-day repurchase rate as its policy rate. The Monetary Policy Committee signals shifts in monetary policy stance through an announcement