

FX, Fixed income, Econ, Facts & Fallacies

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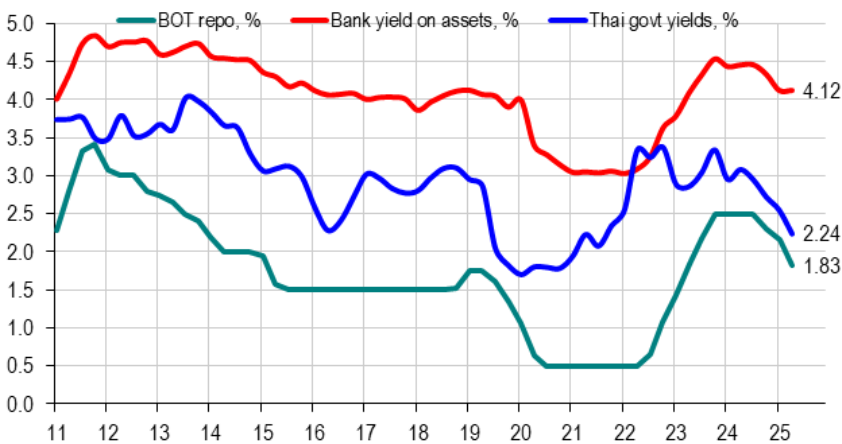
Dr.Kobsidthi Silpachai, CFA

kobsidthi.s@kasikornbank.com

Pinning too much hope on the central bank policy rate?

- Here we go again, calls for the central bank to aggressively cut the policy rate are building momentum as Thailand faces many headwinds. Is the policy rate a panacea to fix all of Thailand's headwinds, or is there too much hope being pinned to the policy rate? Are Thailand's problems a matter of demand or supply? Monetary policy would be effective if it were a matter of the demand side. "Can't Buy Me Love", the '60s hit by the Beatles, suggests that money can't solve everything. However, in the financial markets, money is practically everything. So, which is it?
- Monetary policy incorporates demand-side tools, and the policy rate is one of these tools. Consider the characteristics of the policy rate: 1) it is short-term and 2) minimal Thai credit risk (i.e., central bank credit risk). We attempt to assess the relationship between Thailand's policy rate and commercial and government interest rates.
- Figure 1 shows the quarterly average Bank of Thailand (BOT) policy rate (as the independent variable), and the estimated yields of commercial bank assets and Thai government bond yields. Just eyeballing the datasets suggests some positive relationships, i.e., when the BOT repo goes up, estimated yield on bank assets and Thai government bond yields also go up, and vice versa.

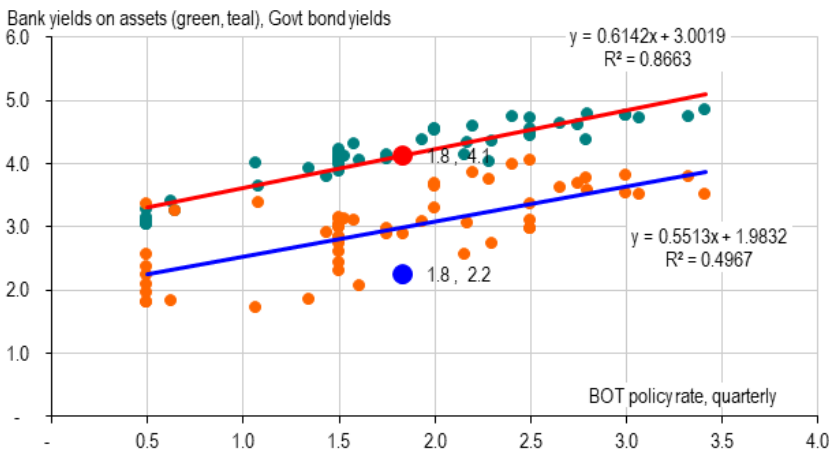
Figure 1: Bank of Thailand policy rate, estimated yield of bank assets, and Thai government bond yields



Source: Bloomberg, KBank

- A simple model showing the estimated yield of bank assets and Thai government bond yields as a function of the BOT policy rate is shown in Figure 2 to understand the relationships better. Figure 2 shows the quarterly average BOT policy rate (as the independent variable) relative to the estimated yields of commercial bank assets and Thai government bond yields (dependent variables).

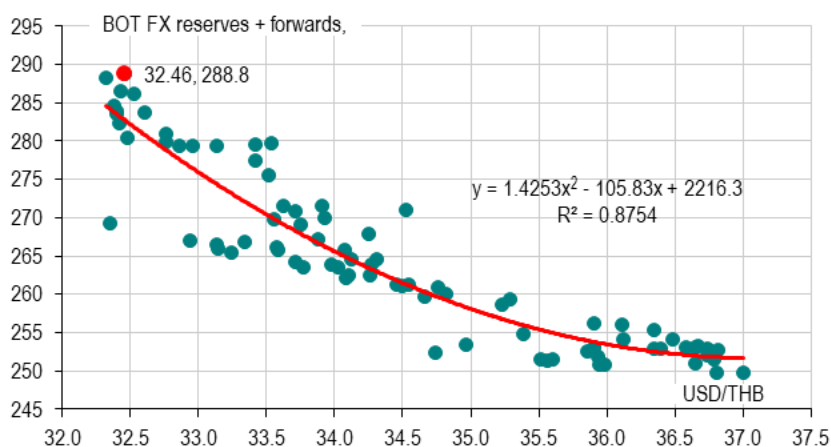
Figure 2: Estimated yield of bank assets and Thai government bond yields as a function of BOT policy rates.



Source: Bloomberg, KBank

- The teal (greenish gray) dots are the datapoints for BOT policy rate and estimated yields of commercial banks, which generated the equation of $y = 0.6142x + 3.0019$, that is, estimated yields of commercial bank assets = $0.6142 \times \text{BOT policy rate} + 3.0019$. This result suggests that for every 1% change in the BOT policy rate, the change in estimated yields on commercial bank assets is about 0.6142%. Meanwhile, the orange dots are the datapoints for BOT policy rate and Thai government bond yields, generating the equation of $y = 0.5513x + 1.9832$, that is, estimated Thai government bond yields = $0.5513 \times \text{BOT policy rate} + 1.9832$.
- Therefore, it can be concluded that there are positive relationships but not effective as a 1 to 1 change, i.e. 1% change in BOT policy rate = 1% change in estimated yield on bank assets or Thai government bonds. Why? Not all interest rates are created equal. The BOT policy rate is a short-term interest rate. The BOT policy rate is free of Thai credit risk. Bank assets comprise a mix of fixed and floating rate, short-term and long-term assets, along with credit risk and credit risk-free assets. Meanwhile, Thai government bonds are not just short-term bonds but have a variety of maturities from those maturing in 2025 up to 2072, equating to a weighted average maturity of 11.72 years. Therefore, the estimated yields on bank assets and Thai government bond yields differ from the BOT policy rate as they have different risk characteristics, such as credit risk and duration risk.
- This shortfall of the policy rate effectiveness is a reason why other central banks, such as the US Federal Reserve, have had to supplement the policy rate (Fed Fund rates) with quantitative easing (QE), i.e., the Fed buys government and mortgage-backed securities (MBS) from the market. Customers have asked us if the BOT could conduct QE. We replied that Thailand would run the risk of being something similar to Zimbabwe or Venezuela (that is, rapid depreciation of local currency and hyperinflation) if the BOT conducts unsterilized QE, as the baht is not a major reserve currency.
- Apart from the policy rate, the BOT also deploys its FX managed float regime. While the BOT has been vocal that its FX managed float regime is not intended to drive the direction of the baht, it is anticipated to smooth out excessive volatility so that businesses exposed to foreign exchange can adapt accordingly. Figure 3 demonstrates this regime, which shows a negative, curvilinear relationship, that is, lower levels of USD/THB are related to higher levels of the BOT's FX reserves

Figure 3: USD/THB and BOT FX reserves & forwards, an illustration of the managed float FX regime.

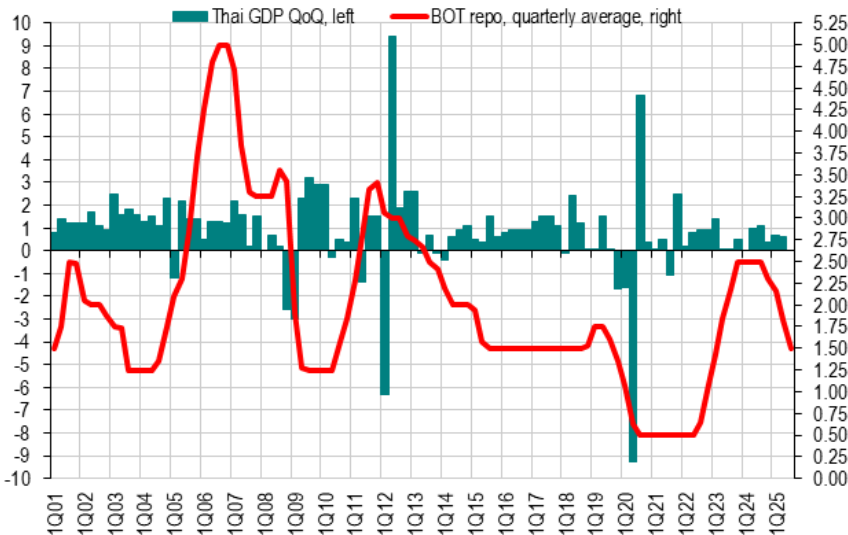


Source: Bloomberg, KBank

- But to come back to the policy rate debate, what is the expected terminal rate of the Thai policy rate in this cycle? History is always a guide for economists, hence regression models are based on past behavior. It should be a fair statement: "We won't know where we are going if we don't know where we have been". Fig. 4 suggests that deep cuts in the policy cycle are usually accompanied by technical recession, i.e., 2 or more quarters of economic contraction. Since the use of the policy rate as a pillar of the new monetary regime post the 1997 financial crisis, the level of 1.25% has been a trough twice in 2003/2004 and post the Lehman crisis in 2008. The record low of 0.50% is owed to the Covid-19 pandemic, which resulted in a 3-quarter economic contraction. We side with the yield curve, which sees a trough of 1.00% in the next 12 months, as the world and global trade grapples with the effects of Trump Tariffs. To cut below the 1.00% threshold borders on "Pushing on a string" as we are in the camp that views Thailand's headwind stems from supply issues (aging population / poor demographics, sluggish progress of major infrastructure projects, and free trade agreements, etc.). Furthermore, consensus still has not tipped the

risk of recession in the next 12 months over 50% (currently at 25%). To call for the policy rate to fall below 1.00% but not call a technical recession would be inconsistent, in our opinion.

Figure 4: Thai GDP, QoQ, and BOT policy rate



Source: Bloomberg, KBank



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