

**Monetary Policy Strategy
for long term growth and price stability**

**Bhanupong
Lecture 24**

Course Syllabus

Lecture 24: Monetary Policy Strategy

- The role of monetary policy in stabilizing growth and maintain price stability.
- Trade-off between inflation and output.
- Monetary policy response of the Bank of Thailand is analyzed in relation to inflation target, changes in the federal funds rate, and asset price bubbles.

Main Themes

- Should the Bank of Thailand tighten its credit policy to cool down inflation?
- Did monetary expansion stimulate growth in Thailand during the global recession 2007-2009?
- How should monetary policy be conducted during the debt crisis in Europe? How does monetary policy affect productive employment?
- “Impacts of quantitative monetary easing Policy in the united states and Japan on the Thai economy” *The Developing Economies* 54, no. 1, March 2016.

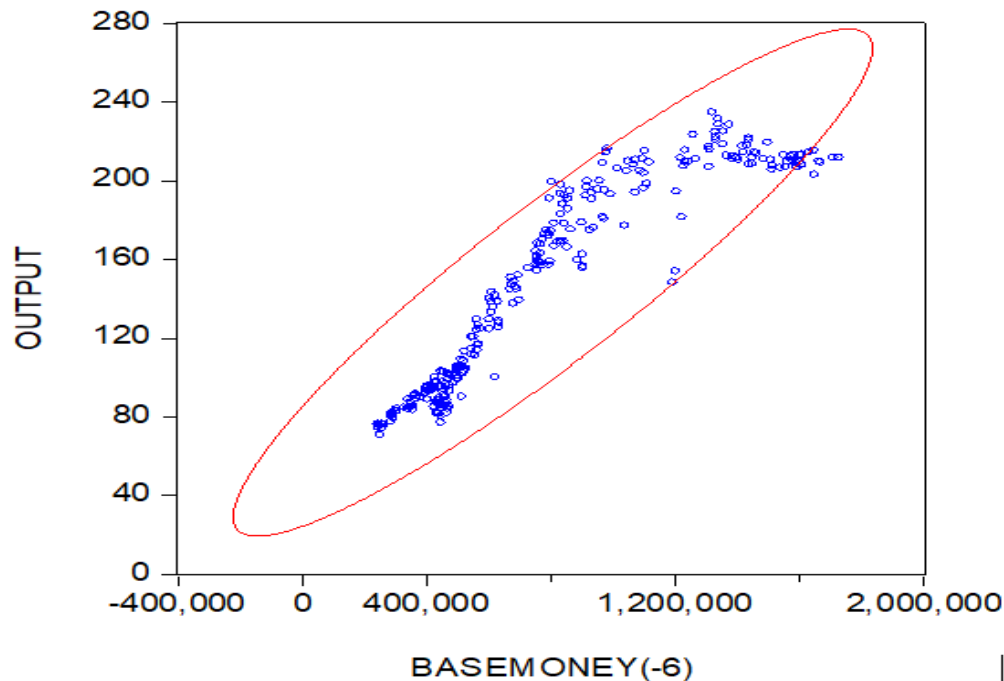
Key Words

1. Monetary aggregate and economic activity
2. Monetary policy transmission channels
3. Inflation targeting strategy
4. Asset price bubbles and monetary policy
5. Quantitative Easing and impacts on Thailand

1. Monetary aggregate and economic activity

The importance of monetary aggregates

- What are monetary aggregates?
- There is a long-run relationship between output and monetary aggregates.



Money and economic activity

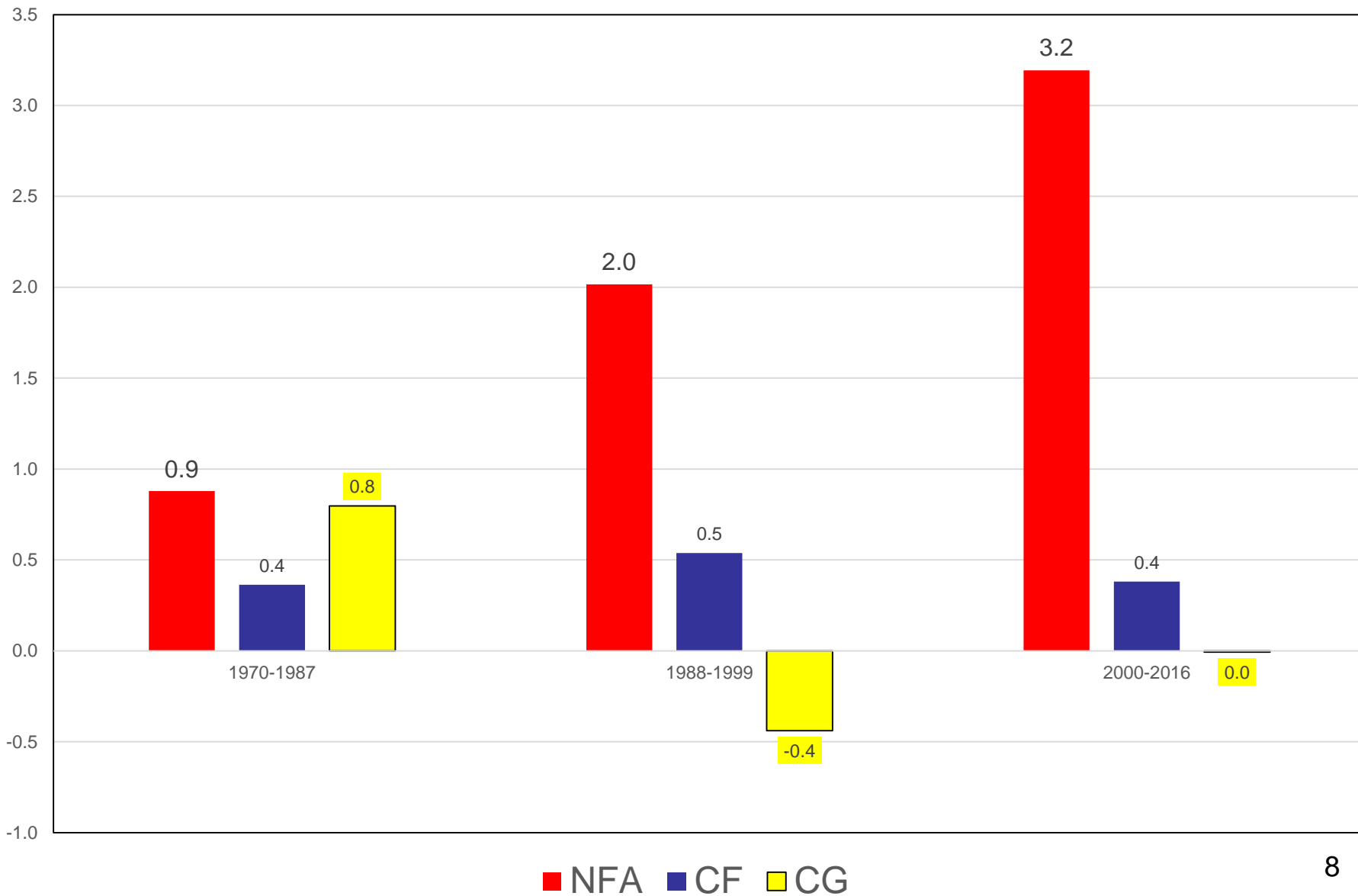
- Broad money which includes physical currency, some sorts of deposits in banks, and some sorts of very liquid securities — has slowed to the point at which it is actually slower than that of the US.
- Growth in money supply is definitely not perfect, but it provides a rough measure of economic activity in the medium term, so acceleration in the US money supply would generally be a good signal, and the slump in China is a very bad thing.

On the Asset side of the balance sheet of the central bank

- Expansion of monetary base (MB) is caused by capital inflows, intervention in the foreign exchange market (NFA), and domestic credit expansion by the central bank in the form of claims on government (CoG) and financial institutions (CoF).

$$**MB = NFA + CoG + CoF**$$

Sources of Monetary Base Ratio to Monetary Base (period average)



On the liability side

- On the liability side of the central bank's balance sheet: $MB = \text{currency} + \text{commercial banks' required reserves (R)}$.
- Whether banks extend loans depends on lending rate (r_L) the cost of borrowing from the central bank (r_p) rate)
- How does monetary policy instrument affect bank lending?

$$Credit = \kappa MB$$

$$\kappa > 1$$

$$MB = NFA + CoG + CoF$$

$$MB = Currency + Bank reserves$$

$$\kappa = \kappa(\bar{R}, r_L, \bar{r}_p, \psi)$$

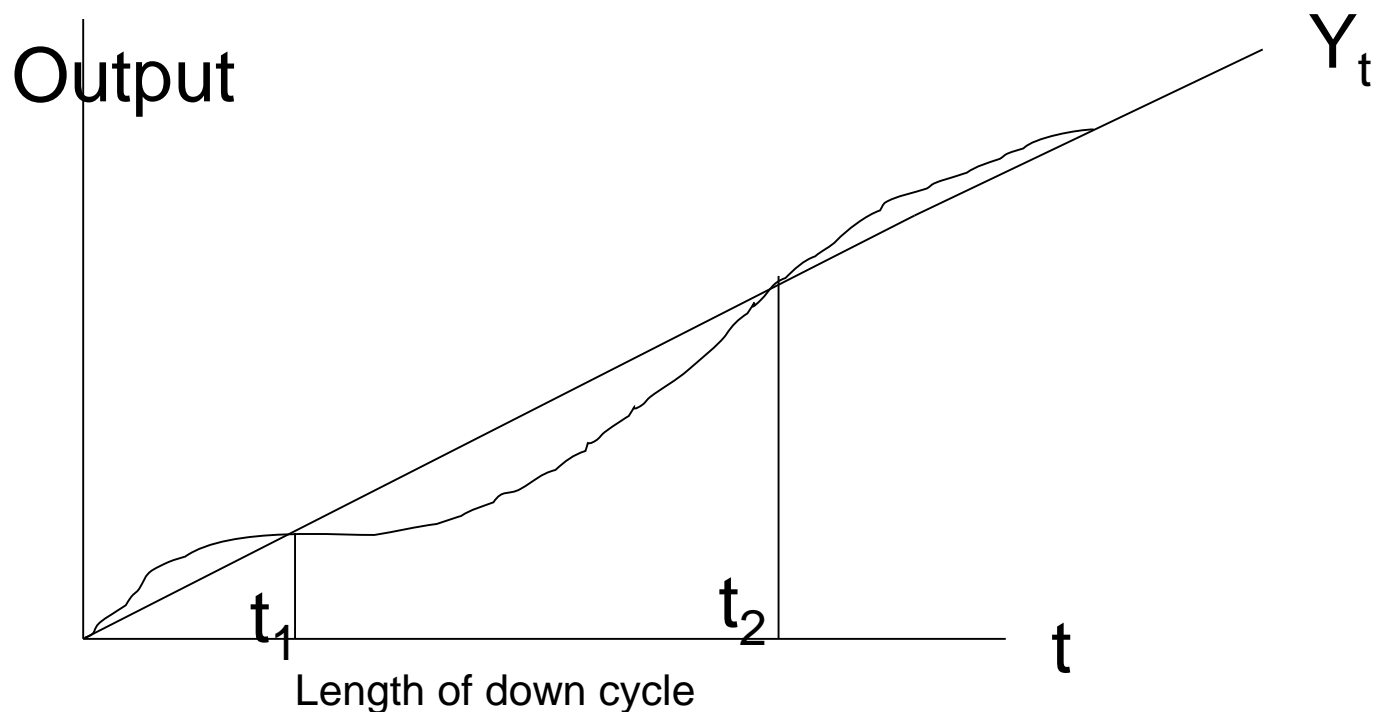
A bar superscript indicates policy instrument

Shocks cause deviations from the long-term growth path

- Long-run output path is dictated by productive capacity (technological innovation) of the economy.
- Monetary aggregates must increase at the rate corresponding to the trend growth rate of real output.
- Credit booms and busts lead to deviations of output from its long-term growth path.

In a mild cycle, output fluctuates around its long-term growth path

$$(Y_t = Y_0 e^{gt})$$



Monetary policy can shorten the duration and
The amplitudes of the deviations

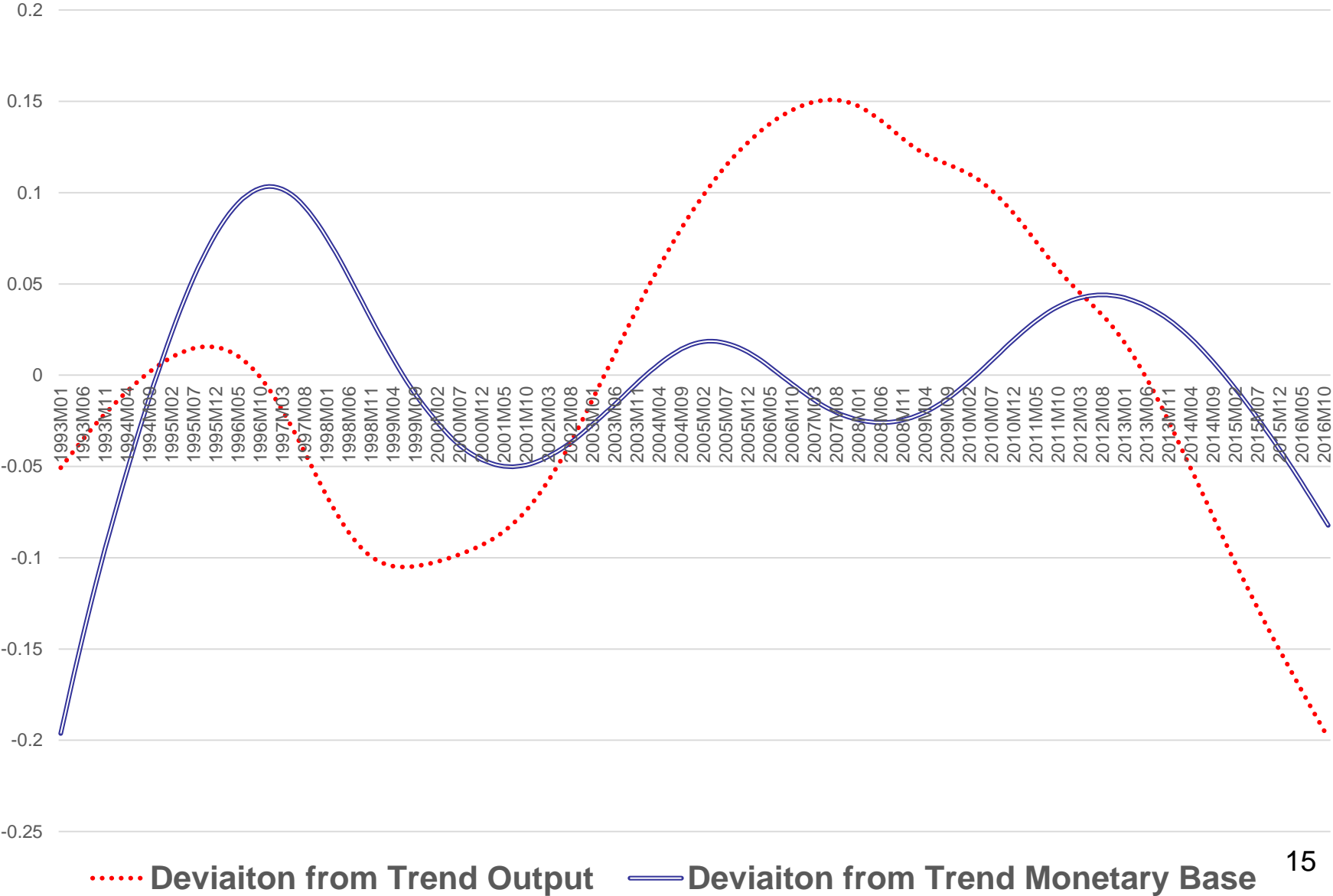
Cyclical Excess: Booms and Busts

- In a **mild** cycle, output growth oscillates around its rising trend: there is no system-wide financial crisis.
- Economic booms and busts can be attributed to **excessive** expansion and contraction of monetary aggregates (money supply, credit, monetary base).

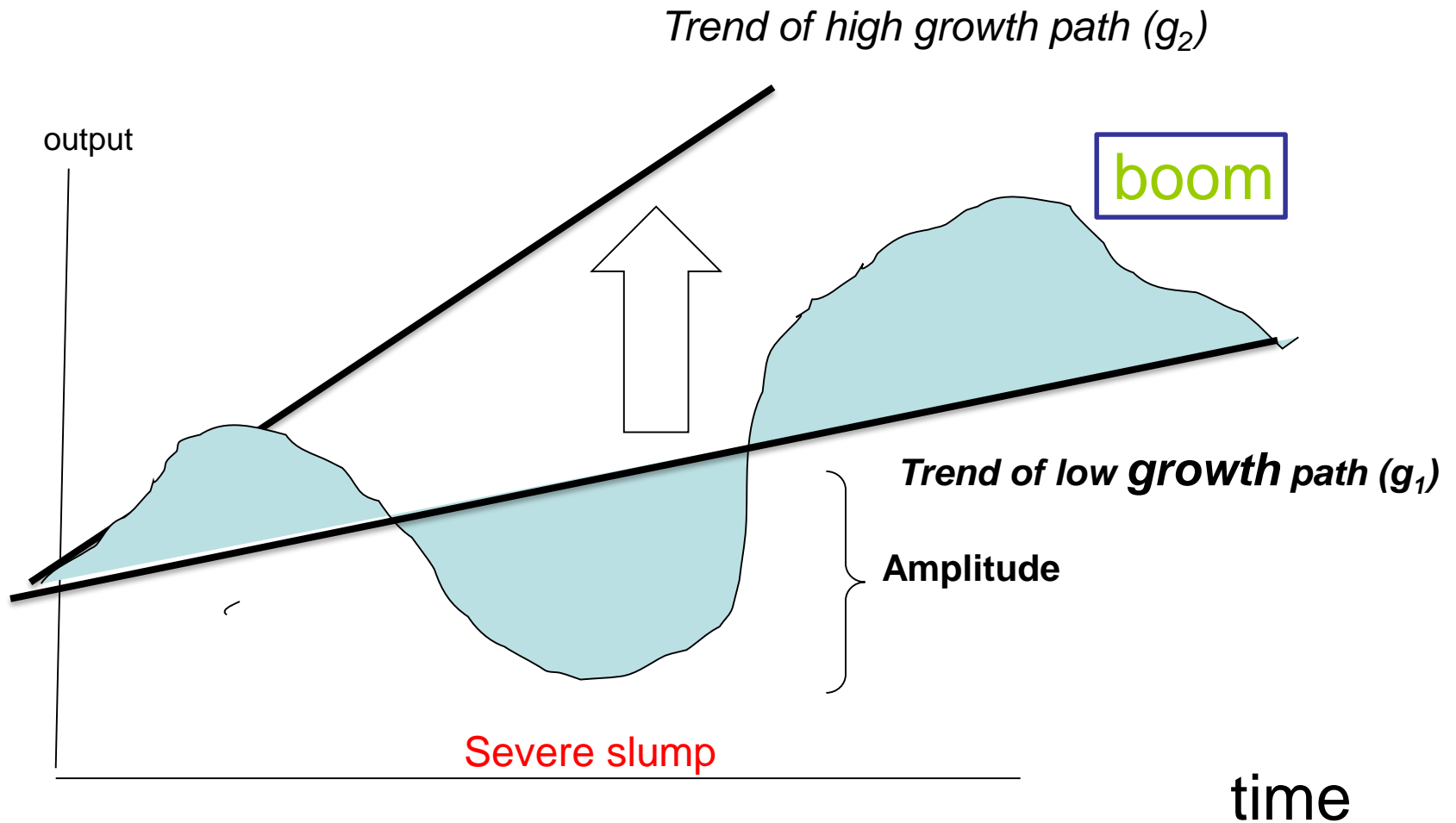
Severe cycles

- In **deep and severe** cycles, the soundness of the whole financial system is threatened.
- In this situation, we are dealing simultaneously with financial crisis and depression.
- Excessive growth of money supply and its sharp reduction lead to wild fluctuations in business cycle.

Output and Monetary Base: Deviations from Trends



Severe Business Cycles



Output responses to credit cycles

- When the monetary base grew excessively over its long-term trend, output growth would expand at the rate **faster** than its normal growth rate.
- When the monetary base contracted below its normal growth path, the economy experienced a downturn.

From peaks to troughs of economic cycles

- The peaks of monetary growth were associated with the peaks in manufacturing output.
- Similarly, the deepest contraction in output synchronized with the trough in the monetary cycle.
- Monetary base changes have a strong impact of output fluctuations.
- Cyclical movements in the monetary base and credit growth rate can be used ***to predict the cyclical movement in industrial output.***

Policy Implications

- Both monetary and output cycles are related.
- The causations run both ways.
- Shocks in the monetary sector can be transmitted into the real sector and vice versa.
- The implication for stabilization policy is that monetary authority should avoid large swings in monetary aggregate.

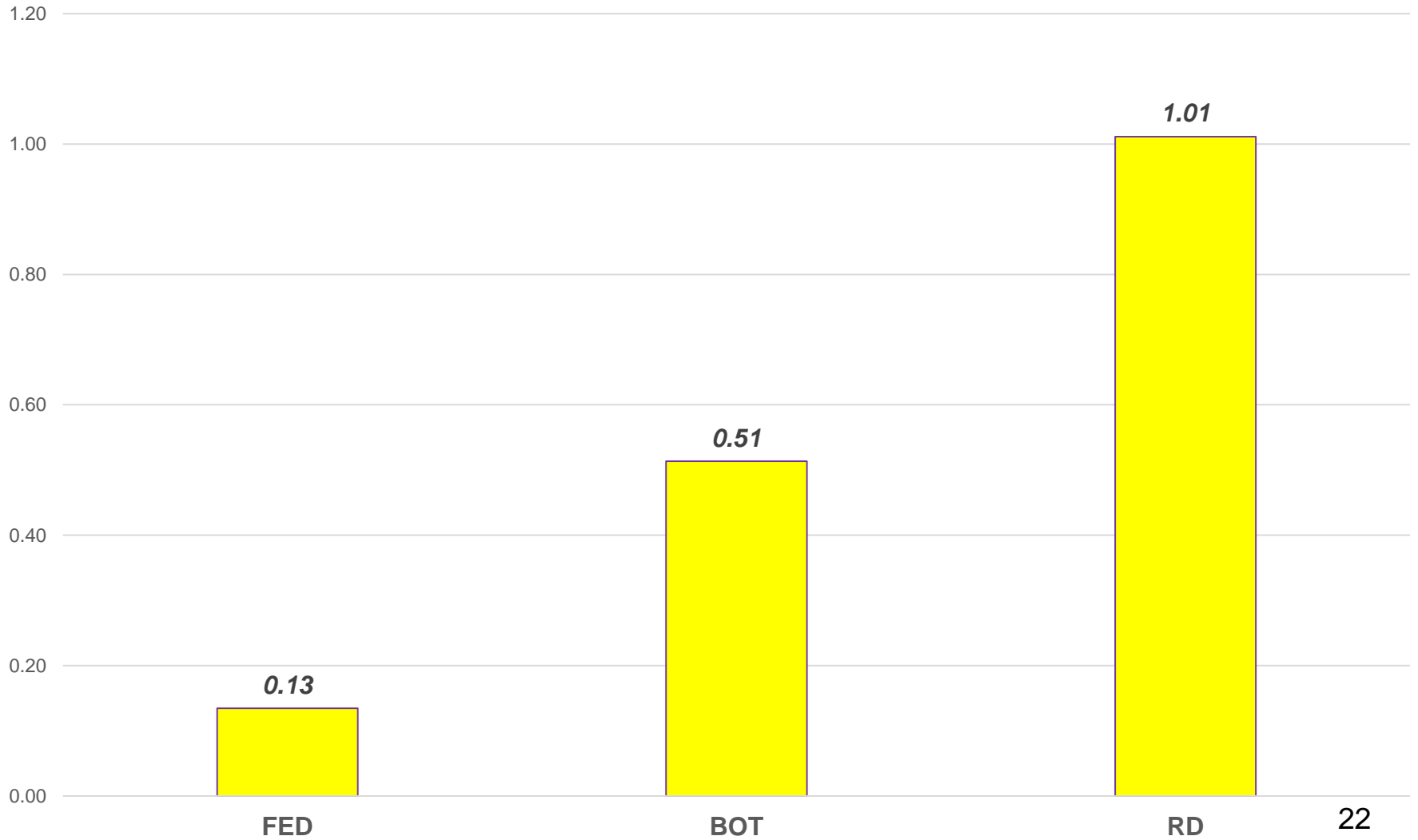
Monetary policy strategy for stable growth

- To maintain a *stable* growth path, **monetary base** must be kept in line with output growth .
- Monetary aggregates: monetary base, money supply, and credit volume.
- Monetary base affects money supply, and credit through money and credit multipliers.
- Note that there are at least six months lag impact of monetary expansion on output level.

2. Monetary policy transmission Channels : interest rates

- Monetary policy instrument is effective in changing the cost of capital.
- Whether the interest rate can exert an immediate impact on the real economy depends on the ***responsiveness of consumption and investment*** to the user cost of capital.
- That responsiveness depends mainly on the business confidence.
- The business confidence index falls below 50 benchmark indicates deterioration of the confidence

Factors affecting MLR
Source: FMOLS Estimated coefficients
(Jan 1993-June 2017)

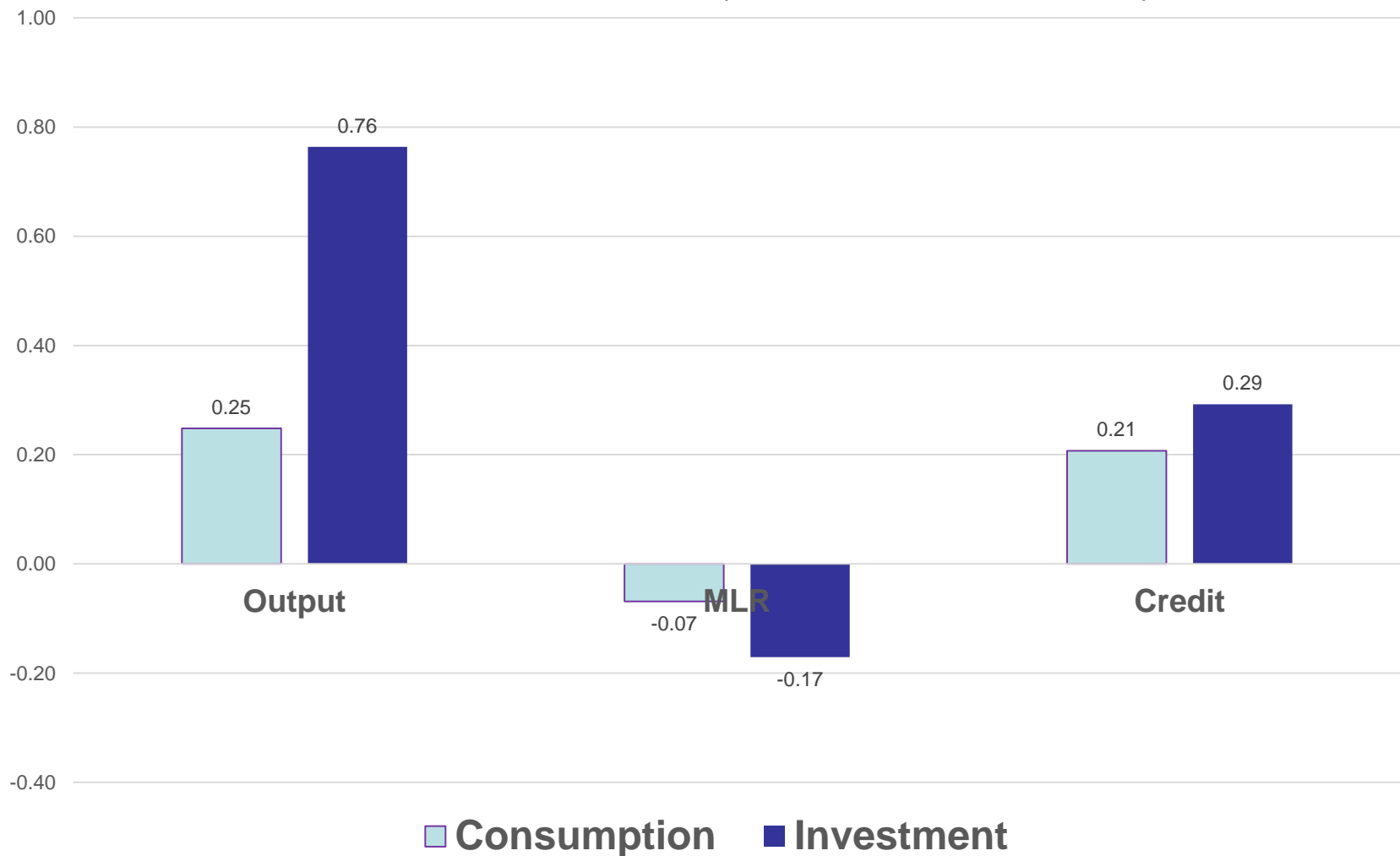


Monetary policy transmission channel: Credit availability channel

- It is not just the cost of credit, but also the availability of credit.
- It is possible that the quantity of credit or credit availability is also vital to investment and durable consumption.
- But credit booms often end badly – and China may be in the grip of a major one, unless China succeeds in a soft landing.

Elasticities of Consumption and Investment expenditures (trend)

Source: FMOLS estimates (Jan 2000-June 2017)



IMF Study: Credit to GDP and risk of a financial crisis

- It is impossible to know the “appropriate” level of credit to GDP.
- This ratio depends on the diversity of the financial system (how bank-centric) and the maturity of its banks, which itself is dependent on such factors as the domestic regulatory environment, culture, and so forth.
- It is easier to make judgments about the growth of credit.
- Rapid increases in credit tend to be a telltale sign of deteriorating loan quality.

Higher Credit-to-GDP Ratio, Greater risk of a financial crisis

- IMF researchers have found that increases in the credit to GDP ratio in excess of 5%-pts in one year were associated with a heightened risk of a financial crisis.
- In Emerging Market aggregate, the credit ratio has increased about 25%-pts since 2008, or 4%-pts per annum for six years straight.
- Importantly, the metric **only** reflects bank loans, but **non-bank lending** also has been strong in some countries.

Emerging Markets

Asia Credit Exposure

- EM Asia credit exposure stands out, in terms both of the level and the expansion in the ratio of credit to GDP.
- China is central to the regional position but the country has company in Singapore, Hong Kong, Thailand, and Malaysia.
- Note that social finance in China, which also includes non-bank credit, stands close to 200% of GDP.

The trigger of the crisis: Fed's normalizing interest policy

- It is not clear how the buildup in EM private leverage will end, or what its repercussions might be.
- One likely trigger is Fed tightening.
- *History suggests a rise in US interest rates will pressure the emerging economies, draining portfolio flows and weakening currencies.*

The outlook for the economy strengthened and inflation is expected to move up in coming months, minutes from the last FOMC meeting showed. Almost all officials agreed that a gradual tightening remains appropriate while some participants see a slightly steeper path of rate hikes. The Federal Reserve also mentioned the prospect of retaliatory trade actions by other countries as well as other issues and uncertainties associated with trade policies as downside risks for the economy.

US FED FUNDS RATE



A trigger of the financial crisis

SOURCE: TRADINGECONOMICS.COM | FEDERAL RESERVE

Higher interest rate raises debt service

- Domestic interest rates are likely to rise, especially in the more stressed countries where monetary authorities are compelled to tighten policy.
- To the extent that EM debt is short-term or floating, these rate increases will boost debt service.
- The likely increase in defaults and bankruptcies will signal banks to curtail lending more aggressively

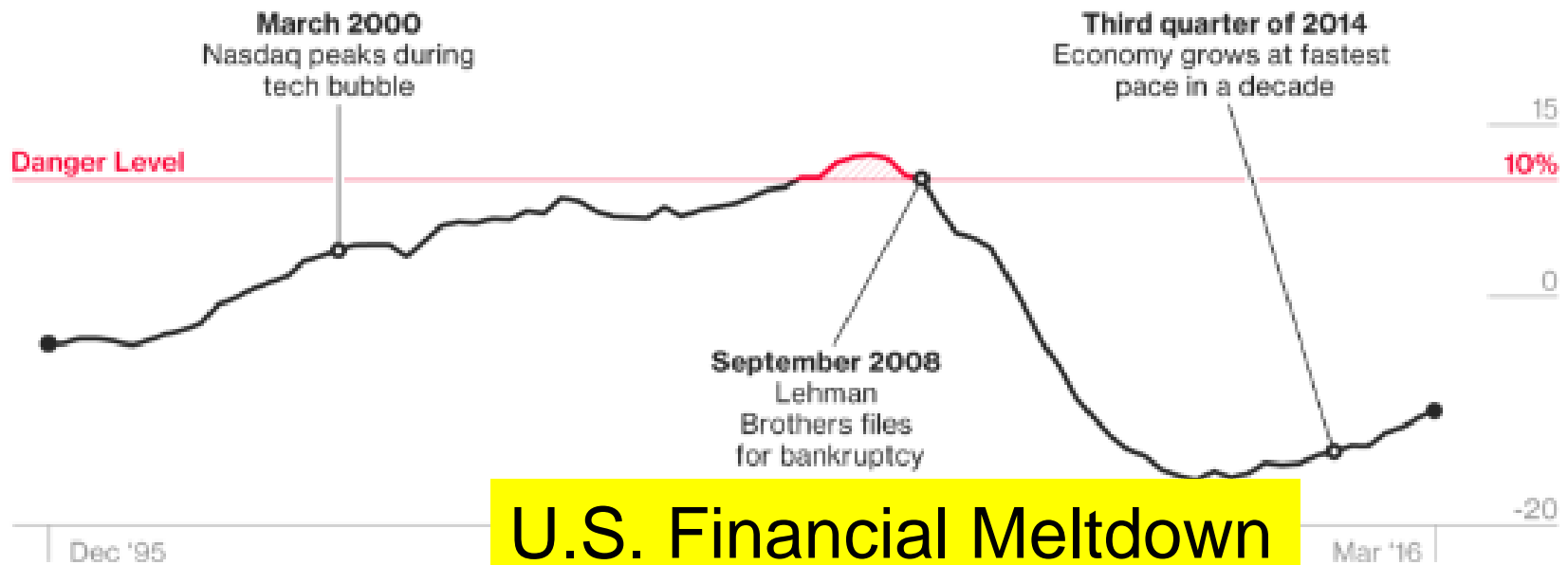
A vicious circle

- This process could become a vicious circle, feeding back on economic activity.
- Recall the two-way causations between monetary aggregates and output
- Some of this debt has been pushed out in duration and some has been issued in local currency, both of which will limit stress.
- The slowing of credit expansion and ultimate deleveraging (reduce borrowing) that has yet to begin poses a threat at a time when EM growth already has downshifted significantly.

Nordic and Japanese crises in the late 1980s and early 1990s followed blow-outs and, likewise, the data flashed red for the U.S. during that country's boom, which morphed into the global financial crisis

$\Delta(\text{Credit}/\text{GDP}) > 5\%$ in one year is a warning sign of financial crisis

U.S. Financial Meltdown



U.S. Financial Meltdown

3. Inflation Targeting

- An **independent** central bank is a requirement for successful inflation targeting.
- Inflationary expectations can be **reduced** since credibility of monetary policy is enhanced by both institutional and instrumental independence of the central bank.
- As more countries have abandoned fixed exchange rates, they desperately need a **nominal anchor** for the price level.

Taylor rule and inflation target π^*

i = Nominal interest rate: key policy rate

$$i_t = \rho + \pi_{t-1} + \phi_1 (\pi_{t-1} - \pi^*) + \phi_2 (y_t - y^p)$$

ρ = the natural real rate of interest
(constant)

y^p = potential output

Φ = a positive reaction parameter

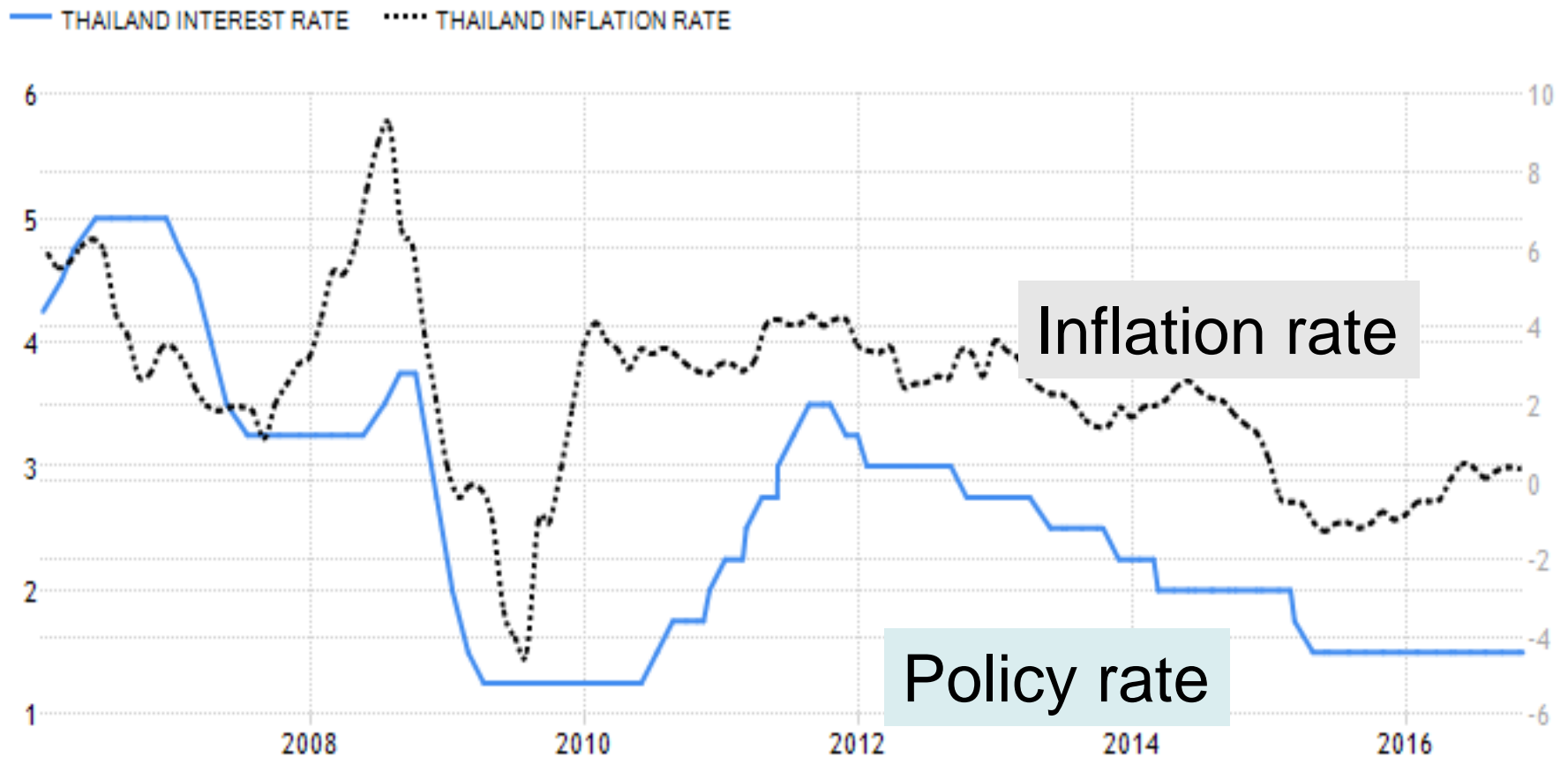
Caveat on inflation targeting

- For countries that are highly dependent on external trade, inflation targeting is akin to targeting the exchange rate.
- Adopting inflation targeting implies a **commitment to no other nominal targets.**
- When there is **no close and stable relationship** between the short-run monetary instruments and long-term interest rates (under developed bond market), a policy rule like the Taylor's rule may not produce a desirable outcome.
- In particular, if monetary policy has a **long and variable lag effects.**

Flexible inflation targeting

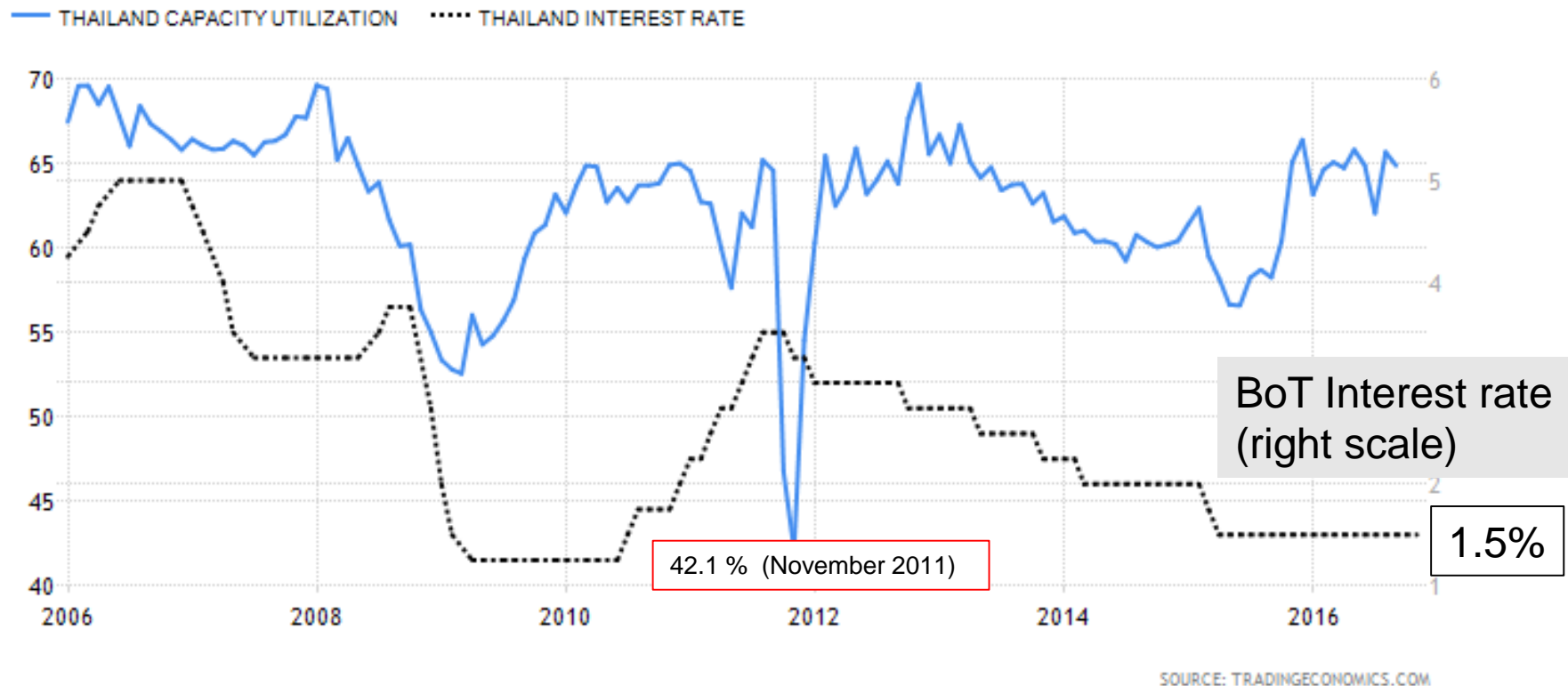
- We are now entering an episode of a slowdown in growth.
- Growth depends less on consumption and investment.
- Fiscal policy has become less effective in stimulating growth.

BoT key policy rate (left scale) CPI inflation (right scale)



The BOT uses the one-day bilateral repurchase transaction rate to signal its monetary stance. Decisions are made by a seven-member MPC currently led by the BoT Governor, whose five-year term began on Oct. 1, 2015.

Capacity Utilization in Thailand increased to 63.65 Index Points in September from 62.98 Index Points in August of 2017. Capacity Utilization in Thailand averaged 62.87 Index Points from 2000 until 2017, reaching an all time high of 70.09 Index Points in December of 2004 and a record low of 42.11 Index Points in November of 2011.



Flexible Inflation Target (FIT)

- Many central banks have adopted FIT
- FRB in 2012 (2% target)
- BOJ announced 2% target in Jan 2013
- But FIT has problems
- Financial stability and prevention of asset bubbles may override FIT
- Under zero interest rate policy, QE may not be effective to achieve FIT

Flexible inflation targeting strategy

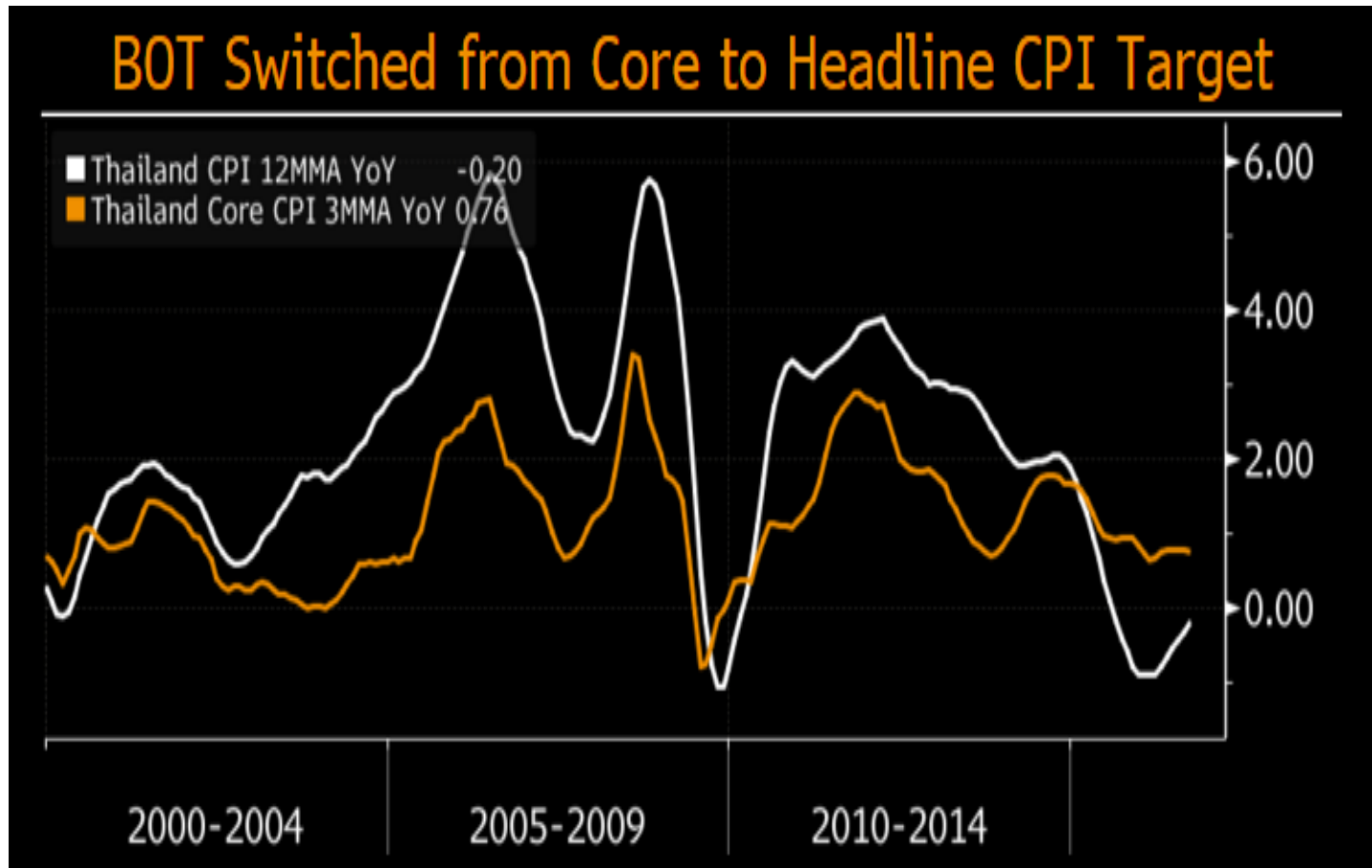
- The central bank key interest rates responds to inflation ***and*** real exchange rate changes.
- There had been an attempt to prevent the appreciation of the real effective exchange rates
- Wrong target? CPI vs. House Prices?

BoT's Flexible Inflation Target:

- The Bank of Thailand has a flexible inflation target framework, paying attention to economic growth and financial stability.
- The goal was previously defined as quarterly average core inflation in the range of 0.5-3% (2009-2014) and 0.0-3.5% (2000-2008).
- Each year the target for the following period is set by the Monetary Policy Committee with agreement from the Minister of Finance and approval by the Cabinet.
- From 2015 to 2018, the objective has been annual average **headline inflation** of 2.5% +/- 1.5 ppt

In 2015, Headline inflation target was set between 2.5 % and -0.5%

Between 2017-2018: 1 - 4%



0.0% - 3.5%

0.5 - 3%

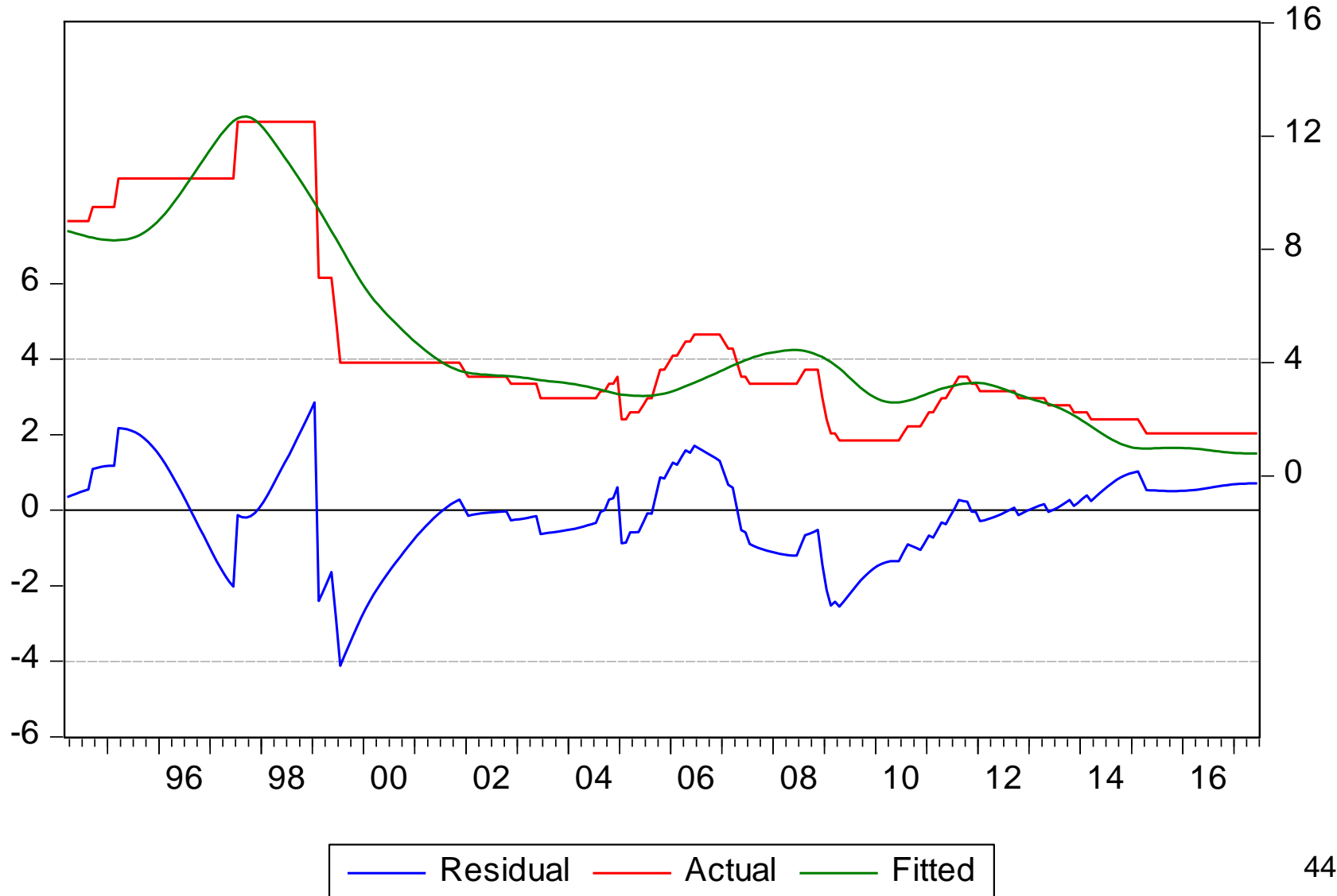
-0.5-2.5%

$$i_t = +\phi_1(\pi_{t-1} - \pi^*) + \phi_2(y_t - y^p) + \phi_3(e_t - e^*)$$

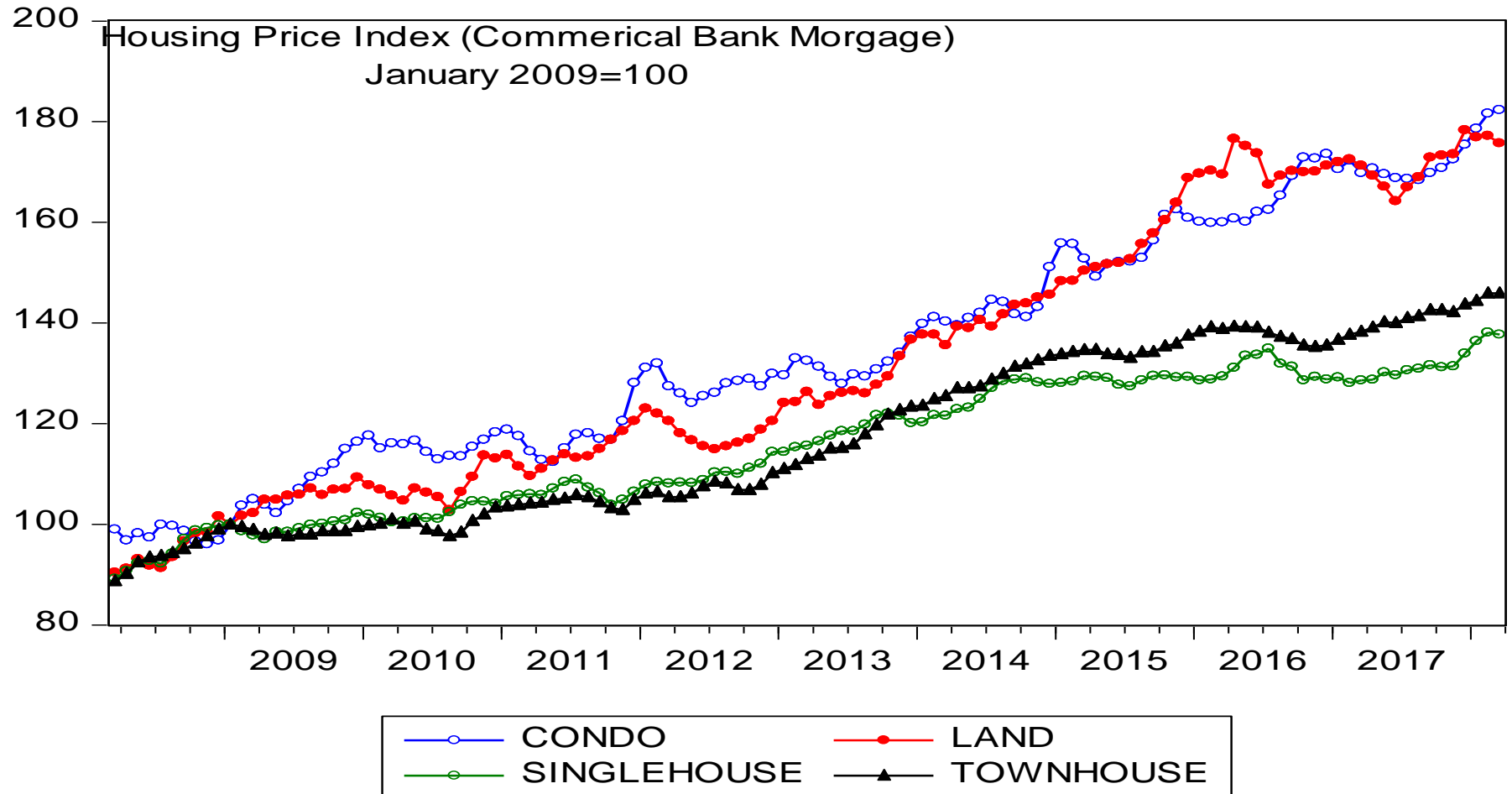
Normalized coefficients in the monetary policy reaction function



The BoT key policy rate



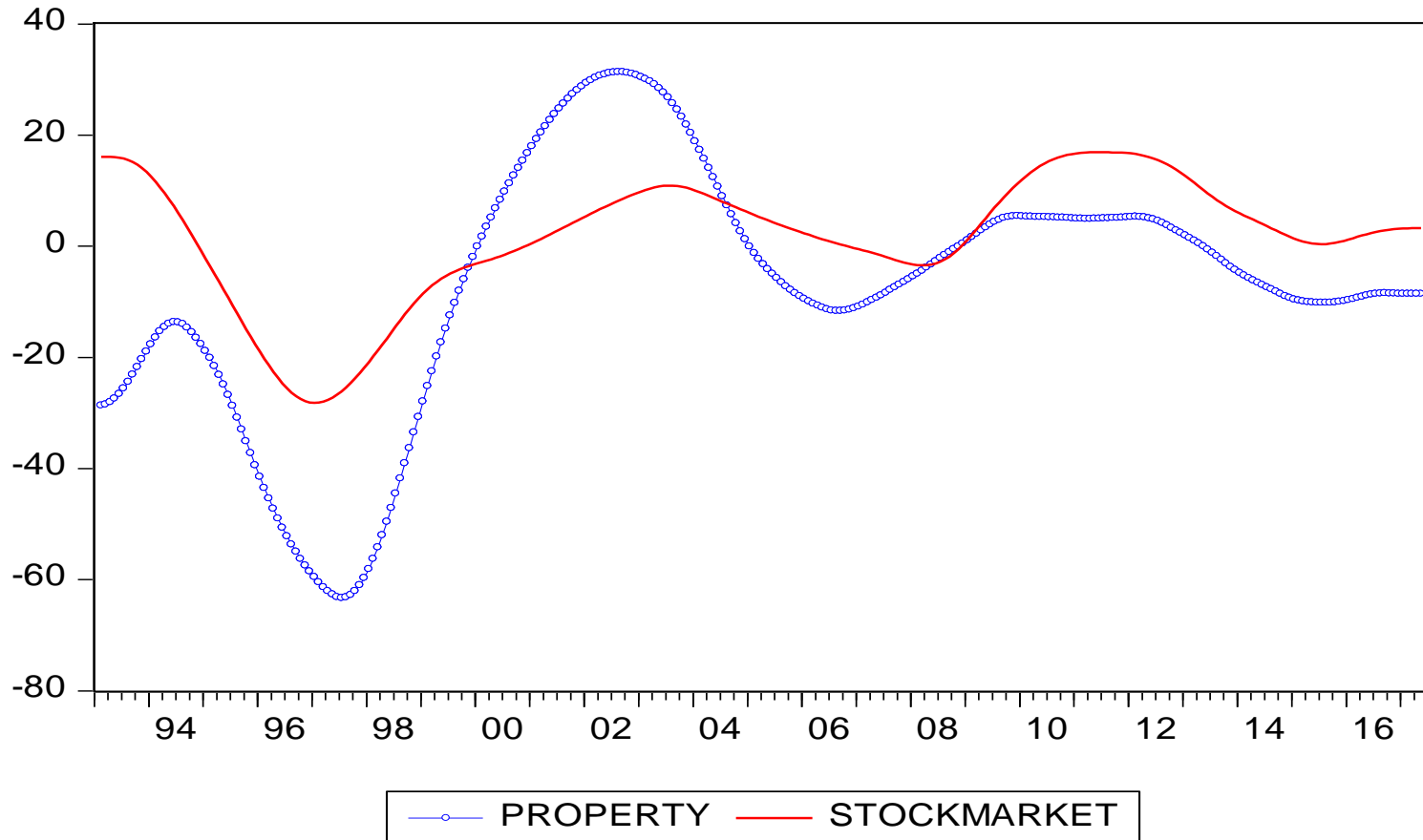
4. Asset Price Bubbles



Approximation of hidden asset bubbles

- The size of the property bubble can be approximated by the **change** in the HP trend of construction activity, represented by permitted construction in urban areas, lagged by six months.
- The size of the stock price bubble can be similarly captured by the **change** in the HP trend of the SET.

Correlates of Stock prices and property sector activity



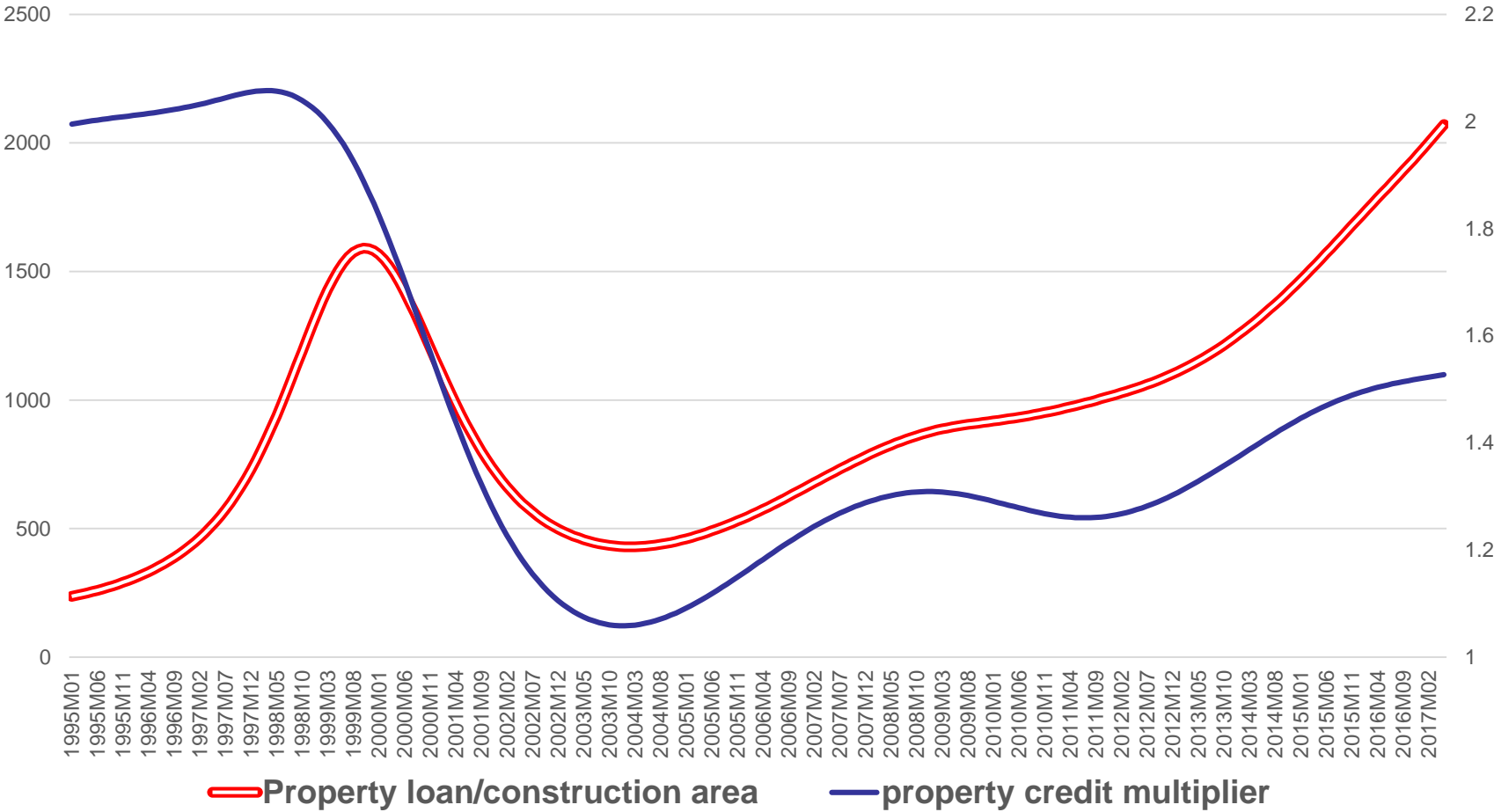
$$Credit = \kappa MB$$

$$MB = NFA + CoG + CoF$$

$$\kappa = \kappa(\bar{R}, r_L, \bar{r}_p, \psi)$$

- Prior to the economic crisis in 1998, there was excessive lending, which can be captured by the rapidly rising credit multiplier.

Excessive Expansion in Property Credit



An early warning indicator

- Credit multiplier increased abnormally high and deviated entirely from the behavior of deposit and money multipliers.
- We can monitor the financial sector by using the property credit multiplier as an early warning indicator for over-lending.

The central bank can prick the bubble

- Rising bank minimum lending rate increases the credit multiplier, while the BOT's lending rate reduces the credit multiplier.
- Deposit multiplier does not lead to a significant change in credit multiplier as the behavior of savers is entirely different from banks.

The central bank and the control of credit multiplier

- There is a significant degree of inertia in bank lending.
- When interest rate is high, commercial banks are willing to take more risk to obtain higher returns from their assets.
- If the Bank of Thailand raises the interest rate on its lending facilities, banks would be discouraged in lending, thereby causing a decline in the credit multiplier.

The causes of property bubbles: Slow supply adjustments and downward sticky prices

- Quantity demand adjusts faster than the quantity supply
- Long gestation period of property development
- Downward price rigidity prevents market clearance.
- Expectations change rapidly, much more rapidly than supply of property development.

A hike in the interest rate may harm condos

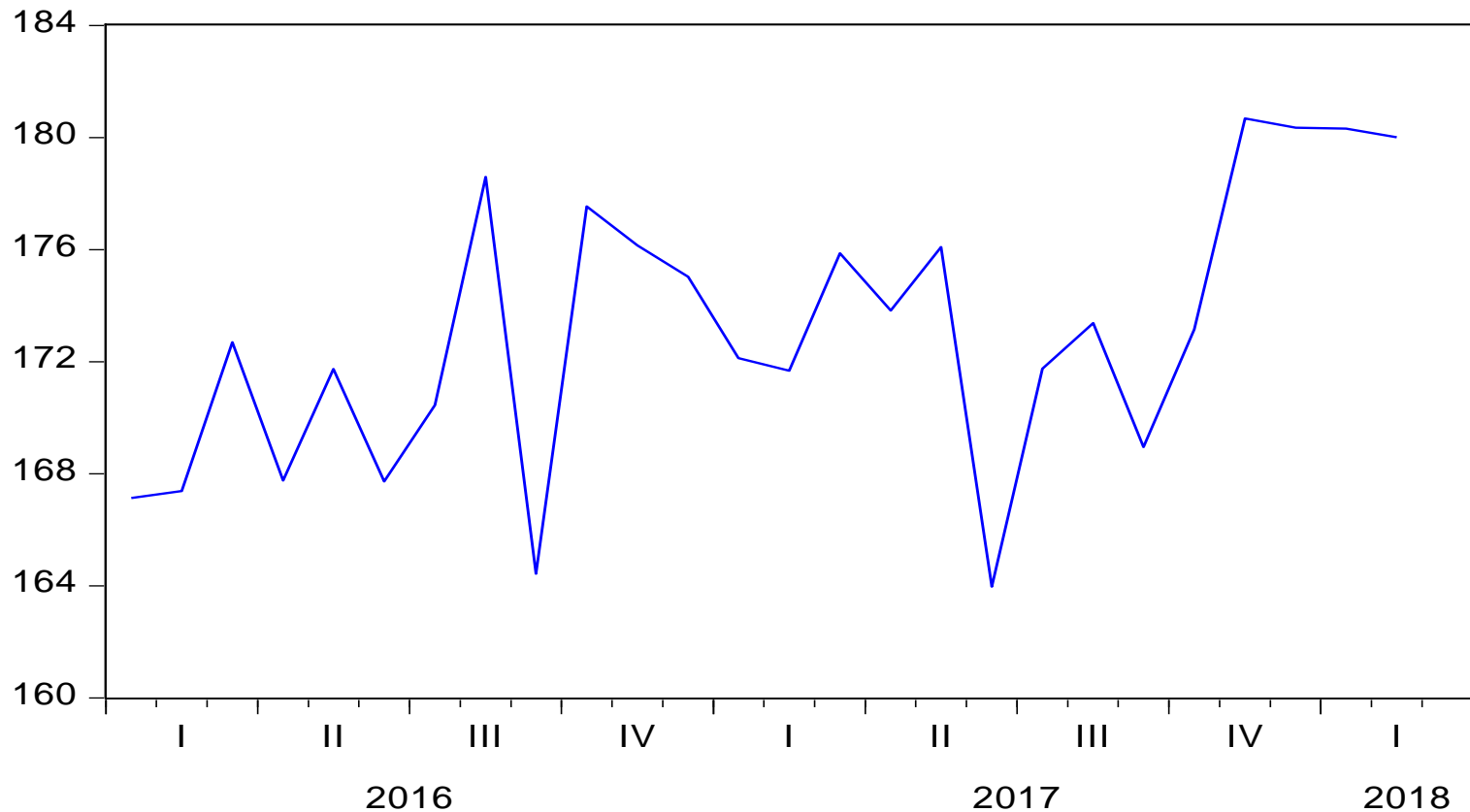
- The sales of backlog of 16 SET-listed developers totaled 294 billion baht at the end of 2017—89% are from condo units.
- Housing inventory exceeded 800 billion baht by market prices. Developers must dispose of this excess inventory.
- In Krun Sri bank's view: "Condos have high liquidity and their prices never fall"

Liquidity Coverage Ratio(LCR)

- The Bank of Thailand has imposed the Liquidity Coverage Ratio (LCR) Framework which replaces the maintenance 6 percent reserve requirement.
- Regarding the LCR framework, all banks shall maintain high-quality liquid assets not less than *net expected cash outflow over the next 30 days*.

A minimum requirement of 60 % in 2016, 100% by 2020

Loan Coverage Ratio



A new macro prudential policy tool

- The LCR has been implemented on January 1, 2016, but the minimum requirement would begin at 60%, rising in equal annual steps of 10 percentage points to reach 100% on January 1, 2020 and thereafter.
- $LCR = \text{Stock of high liquidity assets} / \text{net expected cash outflow over the next 30 days}$

To prevent a property bubble: Maximum ratio of
LTV and LTI

- Loan-To-Value ratio (LTV)
- Loan-to income-ratio (LTI)
- LTV and LTI are examples of macro prudential policy.

Concluding remarks

- It is desirable and possible to prick the bubble by using tight credit policy to curb excessive credit growth.
- Monetary policy is effective in stabilizing the economy, but it should be employed in line with fiscal policy stance and take into account impact of exchange rate (when there is no FX intervention).
- Some novel goals of inclusive and quality growth require other policy mix to bring about the benefits of growth to the vulnerable.

5. QE and impacts on Thailand



The Developing Economies 54, no. 1 (March 2016): 80–102

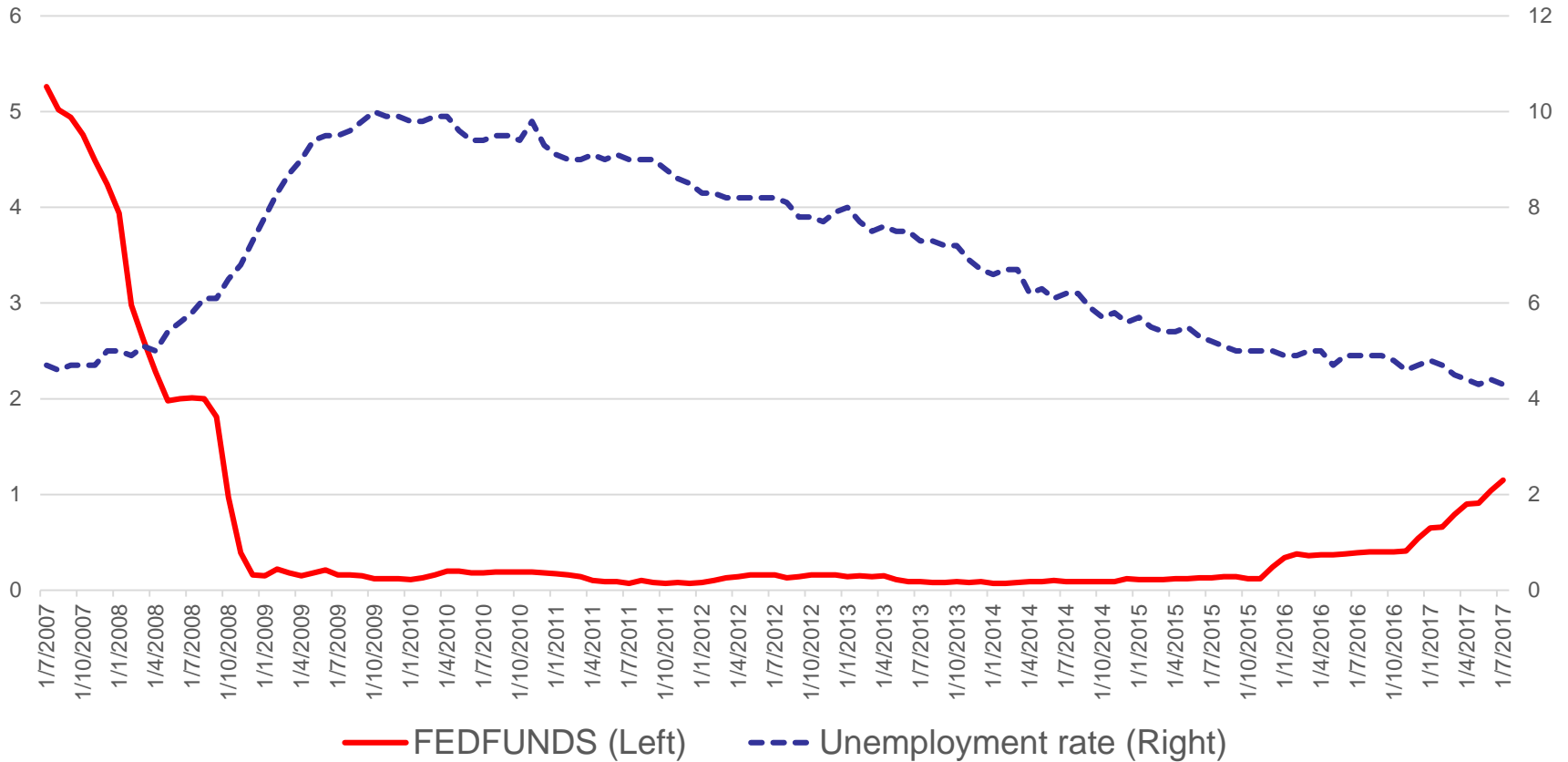
IMPACTS OF QUANTITATIVE MONETARY EASING POLICY IN THE UNITED STATES AND JAPAN ON THE THAI ECONOMY

BHANUPONG NIDHIPRABHA*

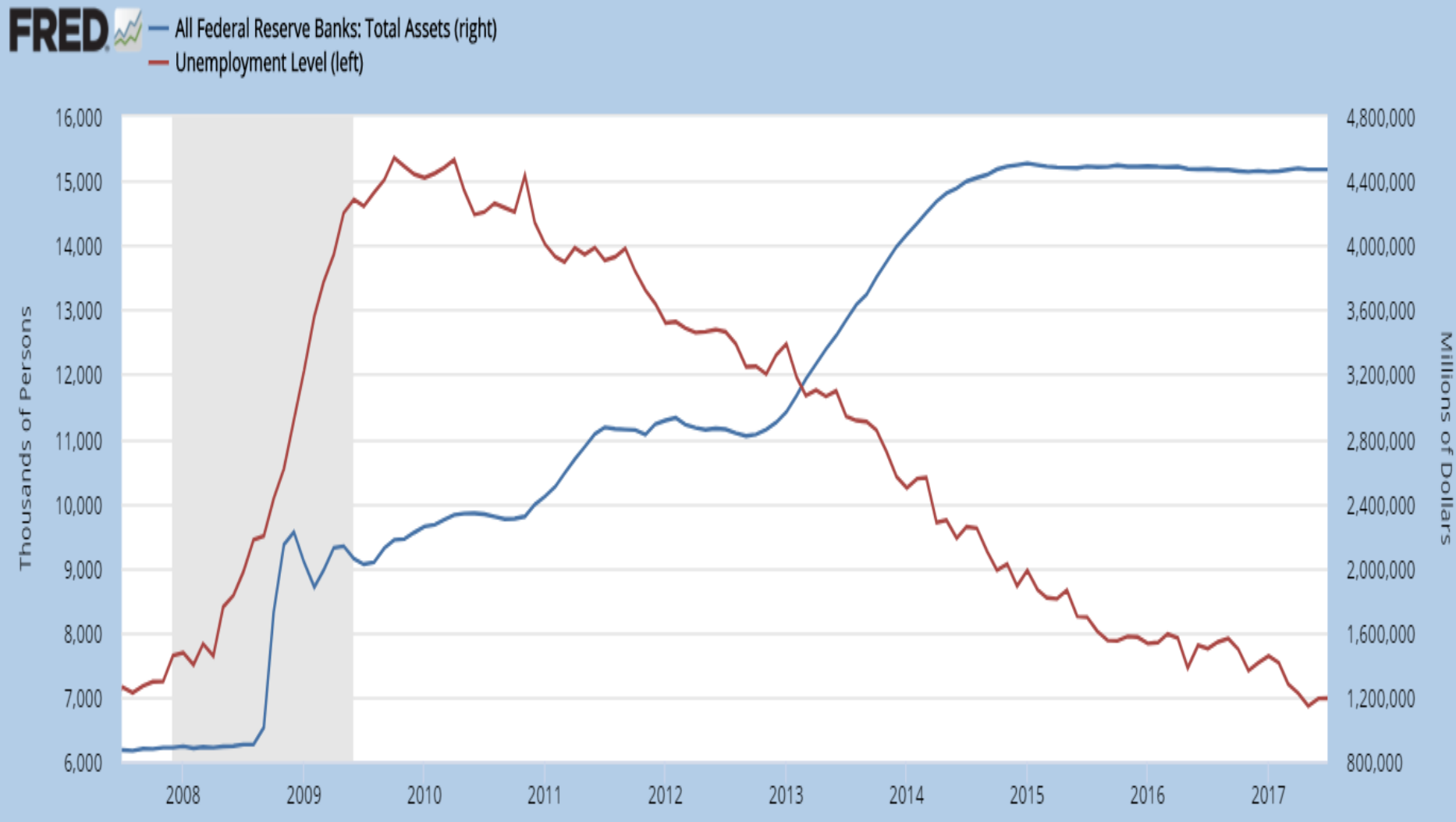
Department of Economics, Thammasat University, Bangkok, Thailand

Taylor's rule is an activist rule

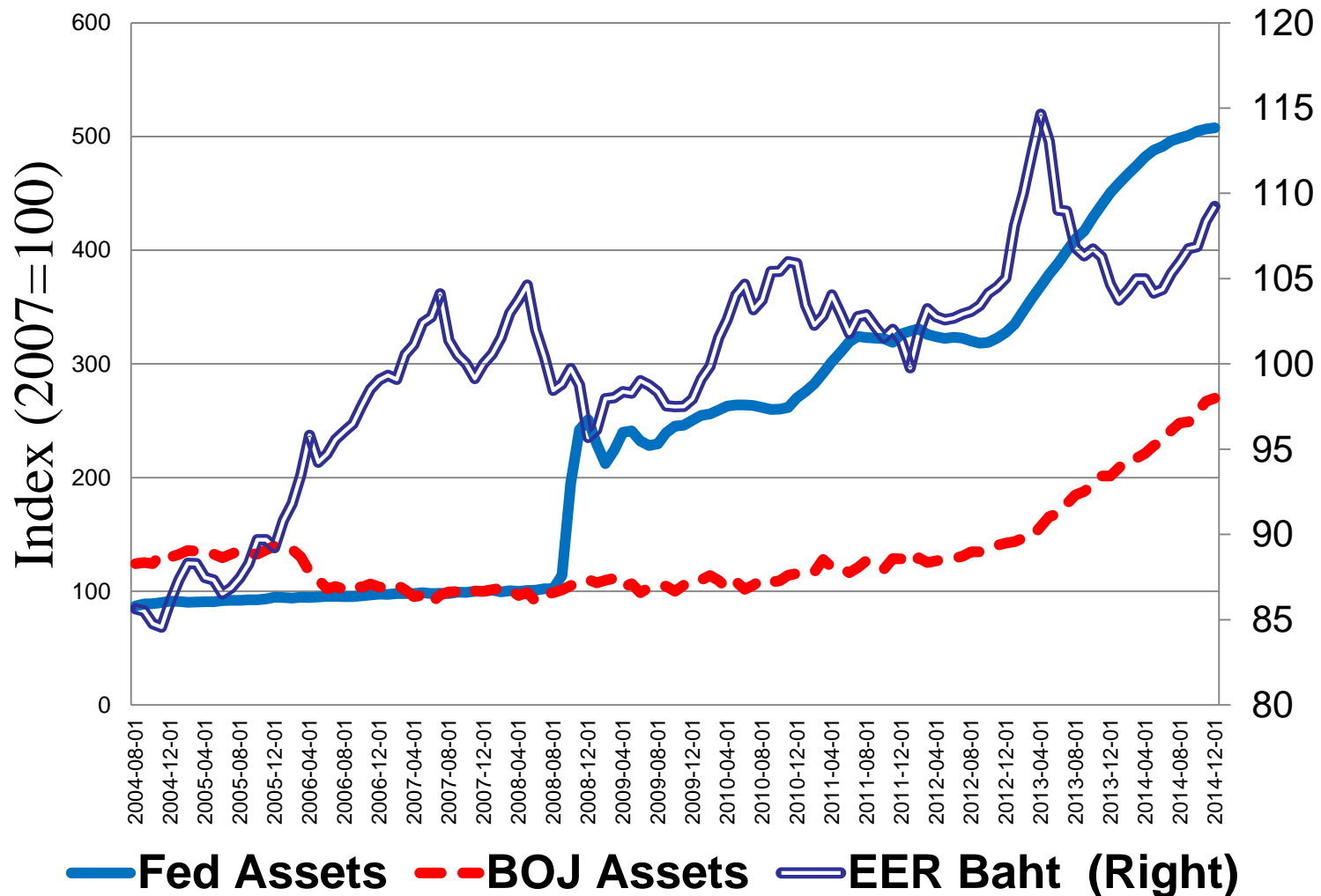
The Fed and Unemployment Rate



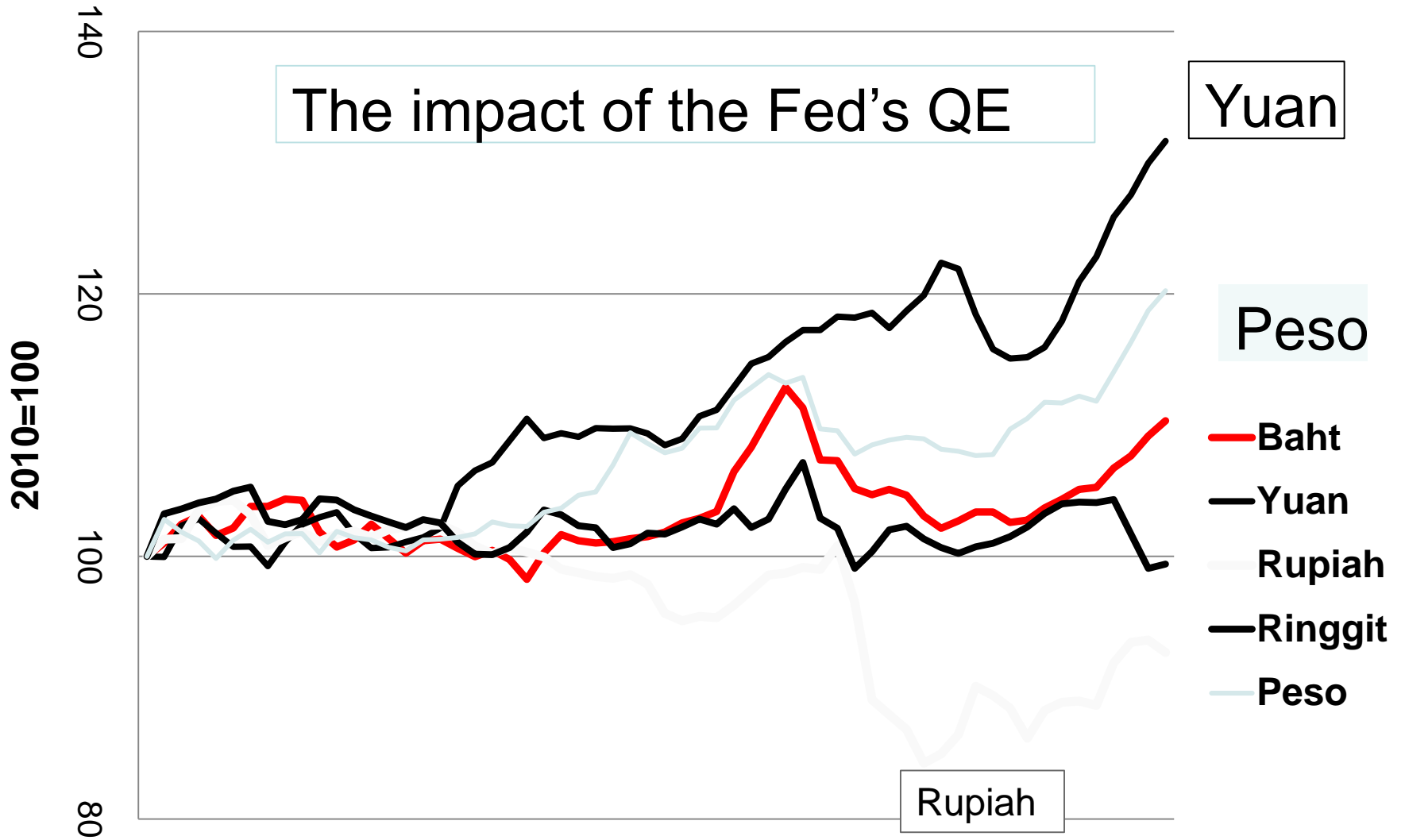
Impact of the FED's Quantitative Easing



Quantitative Easing (QE) Index and Thailand's international Competitiveness: Broad Real Effective Exchange rate (EER)



Index of Real Board Effective Exchange Rates 2010-2015



Conclusions

This paper compares and contrasts the impact of quantitative easing (QE) monetary policy conducted by the Federal Reserve Bank and the Bank of Japan on the Thai economy. The impact of the first round of QE policy is related to Thailand's export market exposures, trade, and financial linkages with the United States and Japan. In the short run, QE has either an expansionary or contractionary effect on Thailand's output depending on whether the baht depreciates or appreciates against the US dollar and the Japanese yen. In the long run, when QE stimulates world output expansion, Thailand's manufactured output and exports respond positively to world economic recovery. In the medium run, the impact of QE is related to the appreciation of the Chinese yuan and the slowing of the Chinese economy, which further depresses Thailand's exports and prolongs Thailand's output recovery.

Keywords: Quantitative easing; Monetary policy; Emerging economies; Thai economy

JEL classification: E40, E58