NOTE

SCB Economic Intelligence Center

Thailand’s financial conditions tightened despite the recent MPC rate cuts.

29 November 2019

- In Q3 2019, Thailand’s financial conditions were tighter than historical average despite policy rate cut by the Monetary Policy Committee (MPC) in August. It was due to persistent Thai baht appreciation, increase in corporate spread, and slowdown in corporate borrowing as well as commercial bank loan growth.
- When compared to the two policy rate cuts in 2015, which has similar economic slowdown as in recent year, the latest round of rate cuts (in August and November 2019) may not be able to deliver as much accommodation as in 2015 due to limited responses from other financial indicators.
- Going forward, with slow and precarious growth in 2020F together with tightened financial condition, EIC expects further monetary and fiscal policy easing. However, MPC may not be able to cut policy rate much further due to potential financial stability risk.
- EIC maintains our view on policy rate unchanged at 1.25% in December 2019 MPC meeting, but now sees rising probability of another rate cut by 1Q20 (40%).

Thailand's financial conditions in Q3/2019

In Q3 2019, Thailand's financial conditions were tighter than historical average despite policy rate cut by the Monetary Policy Committee (MPC) in August[1]. Thailand's overall financial conditions tightened to -1.33 (Figure 1), which was considered tighter than historical average between 2002-2019 (as reflected in the negative reading). Such restrictive financial conditions were resulted from the following developments.

- **Persistent Thai baht appreciation:** Although the August policy rate cut was a surprise decision, it did not lead to significantly weaker Thai Baht (THB). Following the policy rate cut, the THB against US Dollar (USD) remained range-bound between 30.8-30.9, before turning stronger in the subsequent week. In addition, THB continued to outperform relative to other currencies in Thailand trading partners' basket. At the end of August, the Nominal Effective Exchange Rate (NEER) had risen 1.31% compared to the previous month, and as much as 6.84% since the beginning of the year. Thus, the policy rate cut in August had limited impact to ease the THB strengthening pressure.
- **Corporate spread rose from the previous quarter:** With rising both external and domestic risks in August, investors in corporate bonds market demanded higher returns above sovereign yields to compensate for the heightened default risks among corporate issuers. The surge in corporate spreads raised its funding costs for corporates who borrowed in the bond market (rising corporate yields), which contributed to tighter financial conditions.
- **New corporate borrowing in the capital market dropped in Q3:** In 3Q19, new corporate bond issuance fell across maturities (Figure 2). Moreover, with falling yields over the past 5 years, corporates have been raising more funds via issuance of long-term bonds (over 1-year maturity), while shifting away from short-term (less than 1 year) ones. EIC believes that the low interest rate environment has been the major cause of this phenominon, as it induced Thai corporates to to lock-in their declining long-term funding cost. Moreover, the investors' search-for-yield behavior also led to rising demand for long-term corporate bonds, offering higher yields. As for the equity market, new equity issuance remained largely unchanged from the previous period.
- **Slowdown in commercial bank loan growth continued:** Commercial bank loans expanded only 3.8% YOY in 3Q19, down from 4.2% YOY in the previous quarter. This was partly due to the economic slowdown and greater uncertainties surrounding Thai economy. Moreover, NPL in the commercial bank system continued to trend up, especially among SME loans, which experienced a sharper increase in NPL ratio compared to corporate loans. Similarly, NPL among consumer loans was on the rise, largely following deteriorations in credit card and mortgage loans. Against this backdrop, commercial banks had been more cautious in their lending in order to avoid default risks going forward.

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[1] Since the Financial Conditions Index is computed based on quarterly data, only the impact of August policy rate cut is currently reflected in the Index. To assess the impact of the second rate cut in November, we need Q4 2019 data, which will be available in February 2020.

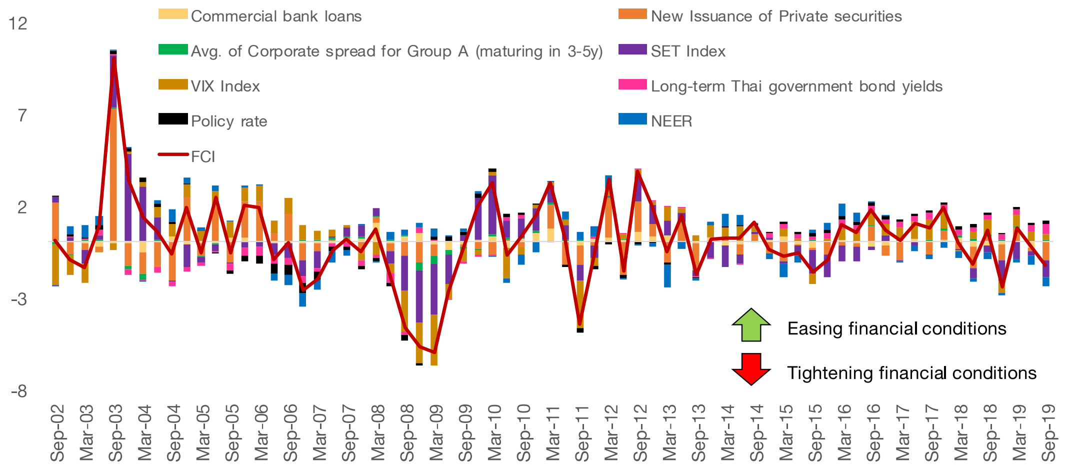
- **The SET index fell in Q3 2019:** Tensions and uncertainties from the US-China trade war, concerns on the worse-than-expected slowdown in Thai economy, and disappointing earnings reports from Thai listed companies had undermined investors' confidence in the stock market. Also, global market confidence has deteriorated, as reflected in elevated VIX index at the end of 3Q19. Such shift in sentiment affected capital flows to emerging markets, including Thailand. Thus, both government bond market and stock markets in Thailand experienced net capital outflows during this period.

- **Nevertheless, the MPC's decision to cut policy rate helped ease financial conditions somewhat by lowering government bond yields.** Short-term Thai government bond yields fell as a result of the policy rate cut and expectation of future monetary policy easing. However, longer-term yields were influenced largely by movements in US treasury yields (10Y), which was falling amidst heightened risks to global economic growth and tensions from US-China trade war that appeared to persist at the time (at the end of Q3). These factors prompted greater demand for safe haven assets such as the US treasury. As corporate spreads have been rising, falling short and long-term Thai government bond yields helped alleviating pressure on the funding costs (corporate yields) for Thai corporates somewhat.

Figure 1: Thailand's overall financial conditions tightened

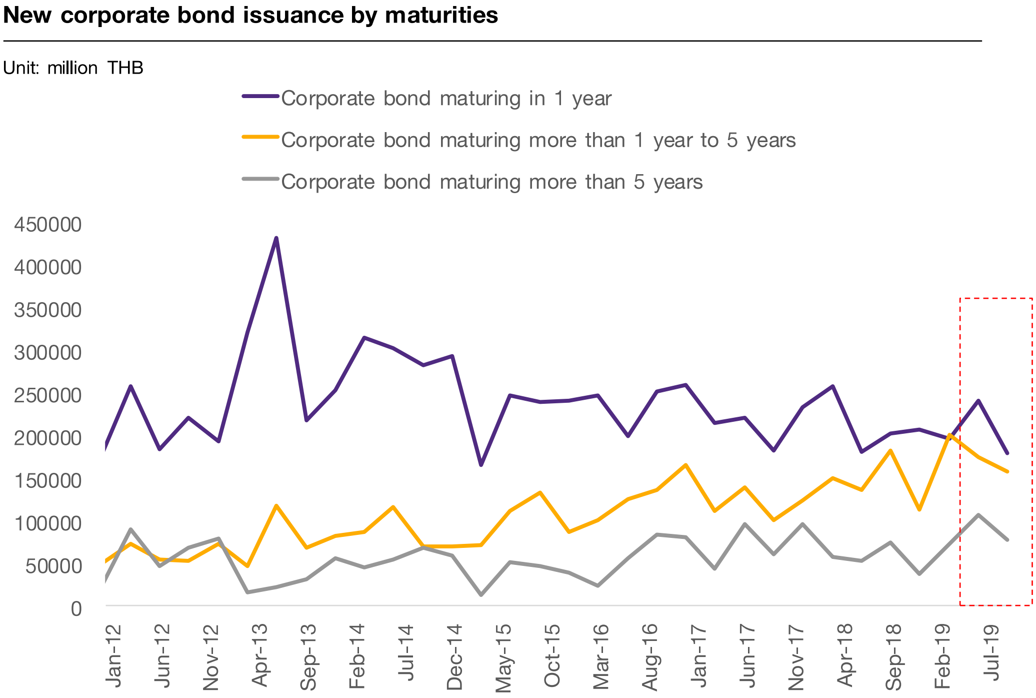
Thailand's financial condition index (FCI)

Unit: Index



Source : EIC analysis.

Figure 2 : In the Q3/2019, new corporate bond issuance fall across maturities and over the past 5 years, corporates have been raising more funds via issuance of long-term bonds.



Source : EIC analysis based on data from The Bank of Thailand.

As other key financial variables have been tightening over 2H19, the recent policy rate cuts (in August and November) could not result in more accommodative financial condition.

- **Most financial variables (excluding policy rate) have been tightening.** The financial variables that EIC has observed includes Thai government bond yields, corporate spreads, NEER, commercial banks' loan growth, SET index, private bond/equity issuance, as well as global financial market uncertainty (VIX). After examining those indicators, EIC found that most of them have led to tighter financial condition. When compared with period prior to policy rate cuts, NEER has appreciated by almost 3%. Corporate spreads have risen by around 12 bps. SET index has declined by 3.4%. Moreover, NPL ratio has increased from 2.95% in 2Q2019 to 3.01% in 3Q2019, leading to tighter credit standard by Thai commercial banks. As a result, loan growth has decelerated from 4.2% in 2Q2019 to 3.8% in 3Q2019. (details in Table 1)
- **With tighter finacial variables compared to 2015, the two recent policy rate cuts in 2019 (August and November) may not ease as much financial condition as two policy rate cuts in 2015.** For comparision, EIC compared the financial condition during Aug-Nov 2019 with those during Mar-Jun 2015. It is found that the Thai economy during those two periods share similar environment. Export sector contracted while private domestic demand (consumption and private investment) decelerated.[2] Moreover, MPC cut the policy rate two times in that period of 2015 (2 consecutive cuts in March and April, with 50 bps in total). Despite the same amount of policy rate cut between the two periods, other financial indicators have been more responsive and policy

[2] However, tourism and public investment saw a strong rebound in 2015.

transmission was more effective during the 2015 period. This resulted in relatively more accommodative financial condition in 2015 than in 2019. In detail, 3 months following the 2015 cuts, short-term Thai government bond yield (1-year) decreased around 50 bps, NEER depreciated around 3%, loan growth of commercial bank accelerated by 1.4%, and Thai corporates were able to raise more funds in the capital market. (details in **Table 1**)

Table 1 : The Comparision of two policy rate cuts in 2015 and the recent rate cuts in 2019

Change in financial variables		
Variables (unit)	**MPC Meeting on Mar 15 (11 Mar 15 to 29 Jun15)**	**MPC Meeting on Aug 15 (7 Aug 19 to 25 Nov 19)**
Policy rate (ppt)	-0.50	-0.50
1-year government bond yield (ppt)	-0.47	-0.41
10-year government bond yield (ppt)	0.20	0.00
Average corporate spread A-group with tenor 3-5 years (ppt)	-0.14	0.12
NEER (%)*	-2.88	2.83
SET index (%)	-1.30	-3.39
New corporate bonds/securities issuance (million THB)**	433,811	447,691
Growth of banking credit outstanding (%)**	1.39	0.49
VIX index (change)	2.16 (from 16.69 to 18.85)	-8.30 (from 20.17 to 11.87)

Note: Data as of 21/11/2019

*lasted data as of Oct 2019

**In the MPC meeting on Mar 2015, change apply for 11 Mar 2015 to 29 Jun 2015, and In the MPC meeting on Ang 2019, change apply for 7 Aug 2019 to 25 Nov 2019

Source : EIC analysis based on data from Bloomberg ThaiBMA and The Bank of Thailand.

Going forward, with slow and precarious growth in 2020F together with tightened financial condition, EIC expects further monetary and fiscal policy easing.

- **In the second half of 2019, monetary and fiscal policy have been eased consistently** following the policy rate cuts and government's stimulus package. However, given the wide-spreading trade war effects (which affect export sector, employment in manufacturing sector, and non-farm income), strengthening Thai baht, and the slowdown in real estate and domestic car sales, private domestic demand has continue to slow down.
- **EIC maintains our view on policy rate unchanged at 1.25% in December 2019 MPC meeting, but now sees rising probability of another rate cut by 1Q20 (40%).** Despite the policy rate at its record low, the MPC indicated in its statement and minute of meeting that they remain data dependent and further monetary easing is possible if the economy slowdown further. EIC believes that data on private consumption, private investment, employment, and income (both farm and non-farm) would be the key factors for the policy rate determination. Looking forward, EIC foresees those data to remain slow and hence, together with tightening financial condition, sees rising probability of another rate cut by 1Q20 (40% chance).

- **However, EIC believes more than one rate cut (25 bps) in 2020 is unlikely as too low interest rates would result in unintended consequence to financial stability.** First, further interest rate cuts would induce more search-for-yields activity and underpricing of risk by investors. This may lead to potential financial stabilty risk in the future. Second, further interest rate cuts may not help boosting consumption much as household might be induced to save more to compensate for lower interest income.
- **To address the strengthening pressure on Thai baht, the Bank of Thailand has announced relaxations on capital flow and foreign exchange regulations** in November 2019. (For details on the relaxations, please see EIC Flash MPC November 2019). In EIC's view, despite limited impacts in the short-term, these measures should ease appreciation pressure somewhat in 2020, causing financial conditions of this channel to be more accommodative going forward.
- **Further accommodative policy could be implemented through various policy instruments.** Such policies include macro- and micro-prudential measures, for example, LTV measures in real estate sector, lending standards for commercial bank loans, and credit guarantee scheme.
- **EIC foresees fiscal easing to continue.** Regarding easing fiscal policy, EIC believes that similar stimulus package that have been implemented throughout this year, including various types of subsidy and soft loans to SMEs and low-income households, could be extended to accommodate domestic demand in the coming year.

By : Kampon Adireksombat (kampon.adireksombat@scb.co.th)
Head of Economic and Financial Market Research

Wachirawat Banchuen (wachirawat.banchuen@scb.co.th)
Senior Economist

Pongsakorn Srisakawkul (pongsakorn.srisakawkul@scb.co.th)
Analyst

Economic Intelligence Center (EIC)
Siam Commercial Bank
EIC Online: www.scbeic.com