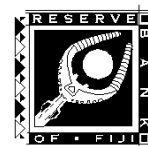


RESERVE BANK OF FIJI ECONOMIC FOCUS



The Transmission Of Monetary Policy In Fiji

The conduct of monetary policy in Fiji has always been a topical subject among policymakers in the public and private sectors. While the conduct of monetary policy itself has undergone significant transformation over the last three decades, there is little understanding on how changes in the monetary policy stance of the central bank is actually passed on to other economic variables. This article outlines how the conduct of monetary policy in Fiji is transmitted from the Reserve Bank of Fiji's (RBF) policy indicator rate (PIR) through to interest rates in the economy and finally to economic activity and its impact on inflation and foreign reserves.

What is the Policy Indicator Rate? The policy indicator rate establishes the RBF's operating objective for monetary policy implementation. The RBF uses the 91 – day RBF Notes rate as its policy indicator rate and this is currently set at 1.75 percent. The RBF's policy indicator rate is used as a benchmark to signal its policy intentions and is quite similar to that of many other countries such as the Overnight Cash Rate in Australia and the US Federal Funds rate. The rate is set in line with the Bank's objective of low inflation and an adequate level of foreign reserves.

When the actual 91-day RBF Notes is not aligned to the policy indicator rate, the Bank exerts pressure either by the sale or purchase of small amounts of RBF notes in the market. This process is called "open market operations" (OMO). The open market operations will be conducted to withdraw liquidity from the system until the actual interest rate is in alignment with the PIR. By maintaining continuous pressure through this process, the RBF is able to influence interest rates up or down.

When the RBF changes the policy indicator rate, like the Board approved policy indicator rate hike from 1.25 percent to 1.75 percent on 28th May 2004, it signals to the market a change in the

stance of monetary policy. That is, a rise means monetary policy is tightened or contractionary and a reduction means that policy is eased or expansionary. The RBF would increase or decrease the policy indicator rate to the levels that it feels helps achieve its twin monetary policy objectives of low inflation and adequate foreign reserves.

The rate at which commercial banks borrow from the RBF is called the Minimum Lending Rate (MLR), which is linked to the actual PIR. Banks sometimes borrow from the RBF when they face liquidity shortfall. Hence, changes to the PIR are automatically reflected in the MLR, which is a cost of funds to the bank.

What is Transmission Mechanism? The transmission mechanism basically describes the channels through which the Reserve Bank's monetary policy operations are transmitted, or passed on to the Bank's final objectives of low inflation and an adequate level of foreign reserves. There are various channels in which changes in policy rate is transmitted to the final objectives. This includes the interest rate, asset prices and exchange rate channels.

However, given Fiji's fixed exchange rate arrangement and the fact that our capital markets are not fully developed, the transmission of changes in policy indicator rate via the exchange rate and asset prices channels is weak.

Under the current monetary policy framework, the transmission of monetary policy in Fiji is chiefly through the interest rate channel. This involves three main stages in the transmission mechanism:

- (i) The flow-on of changes in short-term money market interest rates to other interest rates in the economy, particularly commercial bank lending and deposit rates;
- (ii) The effects of changes in interest rates on economic activity; and

- (iii) The effects of economic activity on inflation and foreign reserves.

The Transmission from the PIR to other Interest Rates in Fiji. The initial impetus of the transmission mechanism is to affect the cost of funds of commercial banks, as this will have flow on effects to the rest of the interest rate structure in the economy and finally growth and inflation. As mentioned previously, the interest rate that the RBF charges commercial banks for collateralized loans is the MLR, which is pegged to the policy indicator rate (i.e., 1.75% [PIR] + 50 basis point = 2.25% [MLR]). Hence, an increase in the policy indicator rate makes it more expensive for commercial banks to source funds from RBF. If banks borrow from RBF, it increases their marginal cost of funds and this is factored into their lending to customers.

The policy indicator rate also affects other interest rates in a number of indirect ways. Firstly, the RBF Notes provide an alternative instrument which institutional investors, like the Fiji National Provident Fund (FNPF), can park their funds in. Since RBF Notes attract a return similar to the policy indicator rate, commercial bank would need to offer a competitive rate to attract and /or retain institutional depositors. Therefore, changes in the policy indicator rates are transmitted to changes in wholesale deposit rates. Lending rates are then priced off such deposit rates in order for banks to maintain their interest spread (difference between lending and deposit rates).

Secondly, the MLR is the ceiling on the inter – bank borrowing rate. Changes in the policy indicator rate are therefore reflected in a corresponding change in the MLR. Consequently, the cost of borrowing rises or falls in the inter-bank market when there are changes in the policy indicator rate.

Finally, changes in the policy indicator rate affect other money and capital market rates. The primary source of funds for non-bank financial institutions is through the issuance of securities in the market. Therefore, a change in the policy indicator rate

affects the cost of funds raised through the issue of securities and accordingly their lending rates get adjusted. Changes in non-bank lending rates also affect commercial bank interest rates as they compete in the same market.

How do Interest Rates Affect the Economy? From the outset, it is important to note that the Reserve Bank does not set interest rates charged by commercial banks. It merely influences the direction of interest rate to desired levels via its conduct of open market operations. As discussed above, under OMO, the Reserve Bank sells its RBF Notes, to withdraw liquidity from the financial system thereby putting upward pressure on interest rates. Alternatively, when it wishes to reduce interest rates, it will ensure that liquidity is plentiful in the banking system. As such, there is downward pressure on interest rates.

Depending on the state of the economy and its impact on prices, the RBF decides on the appropriate policy indicator rate. If the economy is growing too fast, such that prices begin to rise, the Reserve Bank will raise its indicator rate and vice versa if the economy is weak. The actions of the Reserve Bank on the PIR will have flow on effects to other interest rates such as the commercial bank lending and deposit rates.

The rate of interest offered by commercial banks will then affect people's decisions to save or spend. When interest rates are high, people usually save more of their money as this will allow them to increase their spending much more in the future. Also, at high interest rates, people usually borrow less as borrowing costly funds today will mean giving up a lot of spending in the future when the loans have to be repaid. Businesses think the same way. If interest rates are high, they will be reluctant to borrow, as this will raise their cost of doing business.

The decisions of savers and borrowers affect the economy in the same way. If interest rates are high, people will spend less. More money will go into saving and less will be borrowed for spending on consumption and investment goods. If interest

rates are low, the behavior is reversed. Individuals and businesses save less, because returns are lower, and they borrow more since the funds are cheaper. In this case, there is less saving and more spending on consumption and investment.

At some times it is good to have low interest rates, even deposit rates. When the economy is weak, low interest rates encourage people to spend. Therefore, they buy more goods & services, which helps businesses to increase their sales, as well as to produce more. Such developments help

strengthen the economy again resulting in economic growth.

At other times it is good to have high interest rates, even lending rates. If the economy is growing too strongly, there will be inflation. This will raise our import bill and lower our foreign reserves level. In this case it is good to have higher interest rates so that people will spend less. If inflation gets out of control and reserves fall, interest rates would have to go up anyway, and probably by more than they would have needed to otherwise.

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