



WHAT ARE OPEN MARKET OPERATIONS (OMO)?

As the nation's central bank, the Reserve Bank of Fiji (RBF) is responsible for formulating and implementing monetary policy to achieve its dual objectives. In an earlier article, we explained that the twin monetary policy objectives of the RBF are ensuring price stability (i.e. keeping inflation at around 3.0 percent) and maintaining adequate levels of foreign reserves (i.e. sufficient to cover a minimum of 4 months of retained imports of goods and non-factor services).

The implementation of monetary policy involves maintaining an appropriate level of liquidity that is conducive to meeting the central bank's monetary policy objectives. One way to do this is to make changes to the level of interest rates, which can be regarded as the cost of money.

Making changes to interest rates can be approached in several ways. Some central banks use direct methods such as interest rate regulations e.g. enforcing an interest rate ceiling. These controls are more commonly used in less developed economies where market mechanisms are not efficient. Alternatively, like many central banks, the RBF uses market-based tools such as open market operations

(OMO) to influence the level of interest rates in the economy.

This article explains what OMO is, how it is conducted and why it may be necessary, and desirable.

What is OMO?

The Reserve Bank impacts the level of interest rates by controlling the amount of money that is circulating in the banking system. If the RBF wants to influence interest rates upwards, it absorbs money from the banking system. Conversely, it releases money into the system when it wants to influence interest rates downwards. The central bank withdraws money from the system by selling securities and injects money into the system by buying back those securities. The buying and selling of these securities by the central bank is called OMO.

What security is generally used for OMO?

A security, in simple terms, is a document, certificate or instrument that promises to pay the holder a certain amount of money at a particular date. Securities have monetary value and can be traded. Most central banks use government securities to conduct OMO. However, the RBF is one

of the few central banks that use its own securities, called RBF Notes, to conduct OMO.

What determines OMO?

The RBF sets its key or policy interest rate, which is consistent with its twin monetary policy objectives. This interest rate is called the Overnight Policy Rate (OPR). The RBF then conducts OMO using its 14-day RBF Notes to align the overnight interbank rate (the interest rate at which the commercial banks borrow amongst themselves) with the OPR. In practice, if there is a gap between the two, the RBF will sell or buy RBF Notes to influence the level of money in the banking system in order to align the overnight interbank rate with the OPR. If the actual overnight interbank rate is lower than the OPR, the RBF will sell RBF Notes (withdraw funds from the banking system), until the two interest rates are close or equal. If the actual overnight interbank rate is higher than the OPR, OMO will be conducted through buying of RBF Notes (to add funds).

How does OMO work?

OMO works through a bidding or tender system. First, if the RBF wishes to reduce the level of liquidity in the banking system, it advertises in the local newspapers its intention to sell Reserve

Bank Notes. Commercial banks and other organisations bid for these Notes at a price (interest rate) determined by them. The RBF will either reject or accept these bids in accordance with its policy direction. Investors are informed of tender results on the same day.

The successful bidders pay the RBF for the amount of Notes for which they tendered and in return they receive a certificate i.e. the Reserve Bank Note, saying that the RBF owes them some money in the future. The RBF retains this money so that it does not go back into the economy.

On maturity of these Notes i.e. after 14 days, the holders will surrender them to the RBF, which then repays the money with interest.

Who can participate in OMO?

Anyone can participate in OMO. However, given the scale of operations, it is more focussed at large institutions. The minimum amount to participate in the OMO is \$50,000 and the major market participants are usually commercial banks. However, companies and other institutions or individuals are eligible to invest in RBF Notes.

How does OMO influence the economy?

As mentioned earlier, the RBF's OMO influences movements in short-term

interest rates which have flow on effects to other longer-term interest rates such as commercial banks' lending and deposit rates. Changes in deposit and lending rates will in turn influence the saving and spending behaviour of households and businesses, which will ultimately affect economic activity. This transmission process takes time. In more developed markets, the change can have an immediate impact. For other less developed markets like Fiji, the change in policy rates will take some time to work through to other interest rates and ultimately, into the economy. At the same time, the setting of the OPR and its transmission to the economy is not an exact science. A large element of judgement is involved with decisions based on past experience, studies and research.

In the late 1980s, the RBF decided to abandon direct measures like interest rate controls, and adopted market-based OMO to implement its monetary policy. This meant that the level of interest rates would actually rest with the savers, consumers, investors and financial institutions and their ongoing decisions to save, borrow or lend. The RBF simply changes the market operating conditions.

OMO has three strengths of considerable importance: flexibility, precision and size. It is flexible, as any given OMO action can be easily revised or reversed on the same day or thereafter. The process is precise in that the RBF can buy or sell exactly the amount of RBF Notes it wishes. Lastly, OMO can be conducted on any scale. These arguments make OMO a more efficient alternative to using legislated controls and an ideal tool for the day-to-day conduct of monetary policy.