Reserve Bank of Fiji

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Monetary Policy in Fiji

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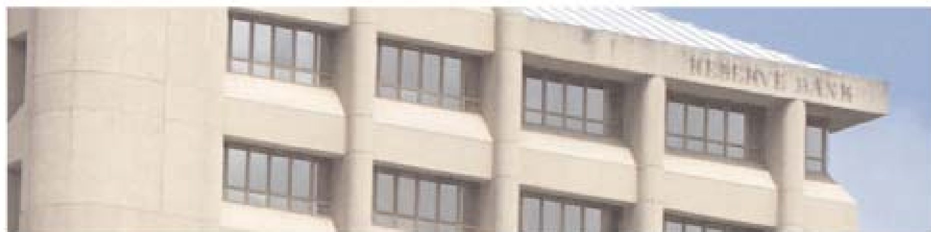

CORPORATE STATEMENTS

OUR VISION

Leading Fiji to Economic Success

OUR MISSION

Enhance our role in the development of the economy
Provide proactive and sound advice to Government
Develop an internationally reputable financial system
Conduct monetary policy to foster economic growth
Disseminate timely and quality information
Recruit, develop and retain a professional team

OUR VALUES

Professionalism…in the execution of our duties
Respect…for our colleagues
Integrity…in our dealings
Dynamism…in addressing our customers' needs
Excellence…in everything

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Foreword by the Governor

Like all central banks, the major role of the Reserve Bank of Fiji is to ensure that the economy is on a stable growth path. We do this by ensuring that inflation is under control, foreign reserves are adequate and the financial system is sound.

When central banks get it wrong, either in the case of a loss of value of the currency, and unstable financial system or high prices, the damage to the country can be enormous. Savings can disappear. Businesses can go bankrupt. Jobs can be lost and lives can be destroyed. The whole society is affected.

So the central bank functions are extremely important to the welfare of the nation. But most people do not know the role of the Reserve Bank of Fiji. Over the years, the Bank has endeavoured to inform the public about its policies and how we implement them. We will continue to seek ways of doing this more effectively.

This booklet on **Monetary Policy In Fiji** seeks to provide a non-technical review of how monetary policy is formulated and executed. This booklet continues our effort to make the public more aware of the functions and operations of the Reserve Bank of Fiji.

I trust that the readers of this booklet will have an insight into the way we formulate our policies and how we implement them. A better understanding of our role as a central bank will add to the efficiency of our policies. Ultimately, policymakers must aim at a common objective and that is to improve the well-being of everyone in the community.

Savenaca Narube
Governor
July, 2004

Introduction

It has been said that "money will not manage itself" and the truth of this statement has been demonstrated on countless occasions. If money is mis-managed or not managed at all, the social, political, and economic consequences can be catastrophic.

The Reserve Bank of Fiji (RBF), like all other central banks is tasked to manage money. This process of managing money is often termed as monetary policy. Like the rest of the world, the formulation of monetary policy in Fiji has undergone significant changes over the years. To a considerable extent, changes in policy formulation have been accompanied by corresponding changes in the implementation approach.

The decisions that the RBF makes in formulating monetary policy are aimed to improve the overall performance of the economy. The implementation of this decision is mainly by influencing the interest rate of commercial banks. The commercial banks interact with the general public, businesses, Government and the RBF in such a way that the total amount of money and credit in the economy is changed. And this change in the amount of money and credit will hopefully have the desired effect on the level of output, employment and prices. The entire process is indirect; no one anywhere has been told what to do. They simply respond to the change in interest rates. Therefore, in making monetary policy plans, the RBF is involved in a dynamic and complex process with other stakeholders.

Types of Monetary Policy Systems

The monetary policy framework adopted by any central bank depends on the state of development in the financial system and the environment within which it operates. In principle, a wide variety of policy systems are possible but, for simplicity, we can put them in two broad categories.

In the first group are countries with floating exchange rates, developed financial markets and no restrictions on capital inflows and outflows. This includes countries such as Australia, The European Union, Japan, New Zealand, and the United States of America. Monetary policy in these countries is guided by domestic economic objectives usually defined in terms of inflation.

The second group of countries are those whose currencies are fixed to major international currencies and who have a certain degree of control over large movements of money into and out of the country. These include countries like Fiji, Samoa and Tonga, and their policies are guided not only by domestic economic conditions but also what happens in their major trading partner economies. For such countries, the other monetary policy objective, apart from price stability, is the maintenance of an adequate level of foreign reserves.

What are the Objectives of Monetary Policy in Fiji?

The objectives of monetary policy are formally established in the RBF Act (1983). These are generally interpreted as having suitable conditions for sustainable economic growth through price stability and maintaining an adequate level of foreign reserves.

Like all central banks, the RBF has price stability as one of its main objectives. However, the RBF does not have a formal inflation target as many central banks in developed countries like Australia, Canada and New Zealand. It is, however, generally comfortable with inflation rates of around 0-3 percent. Low inflation assists businesses in making sound investment decisions and at the same time preserves the purchasing power of incomes, thus protecting our savings.

Maintaining an adequate level of foreign reserves is vital for a small open economy such as Fiji as we depend a lot on imports. In addition, a comfortable level of foreign reserves provides confidence to various economic agents (e.g. businesses and investors) and hence removes speculation on the currency.

What is Inflation and Why is it Important to Maintain it at Low Levels?

Every year the prices of most goods and services change. The rate at which prices change is the inflation rate.

To measure the level of prices, the Fiji Islands Bureau of Statistics periodically conducts a Household Income and Expenditure survey to find out what an average person spends his or her money on. Then the Bureau calculates how much of their income the average person spends on each of the goods or services. To measure the change in prices, the Bureau checks to see how each of the prices of these items have changed over the month. An average is then calculated from the changes in these prices: the prices of goods on which consumers spend more money are weighted more heavily in the calculation; the goods on which the consumer spends less money are given a lower weight.

There are two main causes of inflation in Fiji. Since we spend a lot of our money on imported goods, when prices in other countries go up, the prices we pay for imports also go up. This accounts for

about two thirds of our inflation. The other one third comes from domestic sources. If wages or other costs of production goes up by more than productivity increases, then firms pass this onto customers in the form of higher prices. Other factors, such as cyclones, can also affect prices in the short term.

High inflation is bad for the economy for a number of reasons. Most importantly, inflation reduces the value of money. As prices go up, peoples' incomes, such as wages and salaries, buy fewer goods. The assets that people own, such as cars and houses, also fall in value. It also erodes the value of businessmen's capital. Not surprisingly, people may be reluctant to save or to invest if there is a change in their asset, which may be worth less in the future. Interest rates will also be higher.

On the international front, inflation makes the prices of our exports go up and people in other countries will then buy less of them. Our exporters earn less and have less to spend in Fiji.

Low inflation is a cornerstone of economic growth. It ensures that the purchasing power of incomes is not eroded by price increases. It also provides an environment where cost pressures on businesses, such as demands for wage increases, are contained.

What are Foreign Reserves and Why do we Need them?

Fiji's official foreign reserves are those assets that are held in foreign currencies by the RBF. In addition, the RBF has progressively allowed certain institutions and even companies to hold foreign currency assets. Because they are held outside of the RBF, these reserves are sometimes referred to as unofficial reserves. These reserves are also available to pay for our imports and can be taken into account in calculating the broader definition of adequacy of our reserves.

How do we earn these foreign reserves? There are many sources. We receive the bulk of these foreign currencies from those other countries that buy our exports, from those that lend us money, from tourists and from those who send money to us in Fiji.

Why do we need foreign reserves? Firstly, Fiji does not produce or manufacture all the commodities and products it requires. So we have to import goods such as food, medicine, equipments, footwear, vehicles and many others from abroad. Secondly, overseas companies that sell these goods to Fiji do not want to be paid in Fiji dollars. They want to be paid in their own currency or a foreign currency commonly used for international trade such as the American dollar, Japanese yen, Australian dollar and others. Fiji,

therefore, has to make sure it has enough supply of these currencies to pay for our imports.

If we do not have foreign reserves to purchase imports, or to pay our national debt abroad, supermarket shelves would be empty of all imported food products. Hospitals would not be able to treat the sick properly because of a shortage of drugs and medicine. Buses and boats would be idle, their owners unable to purchase fuel.

Businesses and factories would close, crippled by a lack of goods, raw materials, equipment, machinery and other things they need from overseas. This would lead to unemployment and a whole host of other economic and social problems.

What is the adequate level of foreign reserves that we should keep? The appropriate level depends on an individual country's circumstances and preference. A high level of foreign reserves does not necessarily reflect strong economic performance, as they simply could be a result of low demand for imports arising from slow economic growth. The global rule of thumb is that we should keep reserves equivalent to about 3 months of imports.

How is Monetary Policy Formulated?

The way monetary policy is formulated in Fiji is quite similar to other central banks around the world. The Economics Department of the RBF is responsible for formulating monetary policy.

Senior Economists and Economists. The findings of the meetings form the basis of the proposed monetary policy stance and is submitted to the Monetary Policy Committee (MPC).

The Department monitors the performance of various key economic variables on a continual basis and an assessment of their impact on inflation and foreign reserves are made to the Policy Coordinating Committee (PCC). The PCC members comprise the Chief Manager (Economics) as Chairperson,

Members of the MPC comprise the Governor, Deputy Governor and the Chief Managers of the five departments. This group meets one week before the Board meeting. At this forum, an extensive discussion takes place on the various economic indicators and the appropriate monetary policy setting.

Upon agreement of the MPC, the monetary policy stance is taken to the RBF Board.

The RBF Board determines the appropriate stance of monetary policy. The Board comprises seven directors – the Governor of the Reserve Bank (Chairperson), the Chief Executive Officer for the Ministry of Finance and National Planning, and five community representatives. Meetings are held monthly and changes in the policy stance are conveyed to the public via press releases. These press releases are also posted on the Bank's website (www.rbf.gov.fj).

Monetary policy formulation is not a simple technical matter; it is clearly an art in that it greatly depends on experience, expertise and judgment.

Monetary Policy Instruments

The tools of monetary policy are basically the instruments used by central banks to achieve their monetary policy objectives. These instruments are used to influence interest rates, credit and money aggregates, which then affect inflation and foreign reserves, and in turn economic growth.

The monetary policy framework adopted by any central bank depends on the state of development of the financial system and the environment within which it operates.

Up to 1989, monetary policy was implemented using direct controls. At that time, the financial system was heavily regulated and the RBF exercised controls on the quantity of commercial bank lending and interest rates at which loans were provided. Central to this approach was the control of the quantity of money supplied – the RBF used changes in statutory reserve deposits (SRD) of commercial banks to influence the broad money and credit aggregates and ultimately inflation. In addition, since interest rates on commercial banks lending and deposits were regulated, the RBF also varied the rates to influence monetary aggregates.

However, with the deregulation of the financial system, the RBF began conducting monetary policy using a market-based approach. In 1989, the RBF introduced its own Notes, replacing the previous policy of direct controls on reserve requirements and interest rates. Since then, open market operations (OMO) using these Notes have become the primary instrument for conducting monetary policy. Exactly how the RBF conducts OMO and how this influences commercial bank interest rates and economic activity is discussed in the next few sections.

What are Open Market Operations?

Open Market Operations (OMO) are the purchase and sale of securities to change the level of liquidity in the banking system so as to influence the movement of short-term interest rates. Unlike most developed economies where central banks use Government securities, in the case of Fiji, the Reserve Bank uses its own securities called RBF Notes to conduct OMO.

The Reserve Bank sells the RBF Notes through a weekly auction. By purchasing or selling RBF Notes, the Reserve Bank adds or withdraws funds from the market.

Changes in the level of funds affects short- term interest rates, including that paid on its securities. The RBF does not set interest rates on its Notes. It simply uses its strategic position in this market to create market conditions that drive short term rates to desired levels.

OMO has three strengths of considerable importance: flexibility, precision and size. By flexibility is meant that any given OMO policy can be easily revised or reversed
reversed in a matter of hours or the next day. By precision is meant that the RBF can buy or sell exactly the amount of RBF Notes it wishes. Finally, by size is meant that OMO can be conducted on any scale. These three strengths of OMO make it the best tool of RBF for the day-to-day conduct of monetary policy.

So what is this short-term interest rate that the RBF influences?

What is the Policy Indicator Rate?

The policy indicator rate establishes the RBF's operating objective for monetary policy implementation. In this regard, the RBF uses the 91-day RBF Notes rate as a benchmark to signal its policy intentions. This short-term rate is used because the RBF can easily influence it through OMO. The RBF's policy indicator rate is quite similar to that of many other countries such as the Overnight Cash Rate in Australia or the USA Federal Funds rate.

When the actual 91-day RBF Notes rate 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. By maintaining continuous pressure, the RBF is able to influence interest rates up or down.

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How does the RBF Decide on When and How Much RBF Notes to Issue?

The RBF conducts OMO to maintain the actual 91-day RBF Notes rate at the policy indicator rate. If there is a gap between the two, the RBF will sell or buy RBF Notes to influence liquidity. The aim of OMO is to bring supply and demand for funds in the market into balance with the policy indicator rate.

The gap between the actual 91-day rate and the indicator rate is a function of liquidity. Hence, the decision to issue or buy back RBF Notes occurs when:

(i) The actual 91-day rate is markedly away from the policy indicator rate; and/or
(ii) Liquidity forecast indicate that the actual rate may deviate from the policy indicator rate.

Before deciding how much RBF Notes to sell, proper analysis is done to predict where the market is and where it may be moving. The amount of RBF Notes and the rates at which to accept such tenders is therefore very crucial as it signals the Bank's intentions to the market. The guiding principle in accepting RBF Notes is to issue Notes until our policy indicator rate is achieved.

Once the 91-day rate has reached the indicator rate, small amounts of Notes are floated on a periodic basis to test the market. Consistency in the Bank's signals to the market is very important for credibility and efficiency.

The sale and purchase of RBF Notes to steer the market rate towards the policy indicator rate is a trial and error process. There is no precision in this operation particularly in a small, less developed market like Fiji. Judgment very much plays a big part in such an operation.

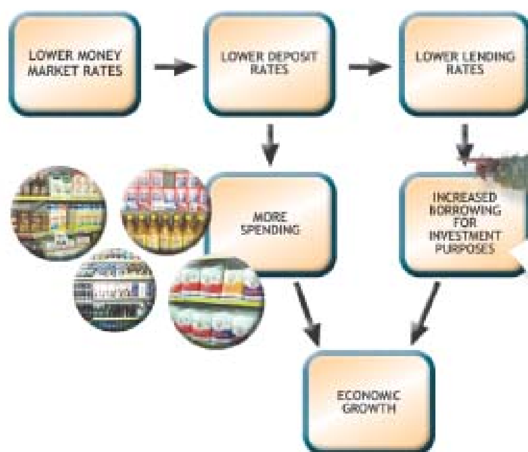
How does Monetary Policy Affect the Economy?

It may be asked how monetary policy can be effective in the management of the economy as a whole when it operates through such a short-term interest rate. In practice, the policy indicator rate has a strong influence on other interest rates, which in turn affects the wider economy.

Under the current monetary policy framework, there are three main stages of how monetary policy affects economic activity and inflation. In the first stage, changes in the policy indicator rate tend to affect other interest rates in the economy, particularly commercial bank lending and deposit rates. Commercial banks' deposit rates gets influenced, as banks have to match the interest rate they pay on deposits with the interest rate on RBF Notes, otherwise there may be an outflow of deposits or vice versa.

Their lending rate gets affected because the cost on deposits are now altered due to the change in the policy indicator rate.

The Transmision of Monetary Policy



In addition, changes in the policy indicator rate results in an automatic change in the interest rate on funds borrowed from the RBF. If the policy indicator rate is raised, it becomes more expensive to borrow from the RBF and cheaper if it is reduced. Hence, if banks' cost of borrowing increases, they would want to offset this by increasing their lending rate.

In the second stage of the transmission, changes in commercial bank interest rates will lead to changes in bank credit and economic activity.

This occurs in a number of ways through changes in savings and expenditure patterns of individuals, and investment behaviour of businesses. Higher interest rates raise the cost of borrowing to finance expenditure. Alternatively, they increase the incentive to save or to delay spending.

Finally, changes in economic activity arising from the shift in spending behaviour of individuals and businesses affect prices, foreign reserves and employment. Demand for certain goods relative to others may see prices of those goods rise. An increase in the demand for imported goods may see foreign reserves fall while investment in a factory that exports items may result in an increase in foreign reserves.

When and Why does the RBF Change the Policy Indicator Rate?

The policy indicator rate is used as an indicator for policy intentions and is set in line with the Bank's monetary policy stance. If, based on the outlook of the economy, in particular that of prices and level of foreign reserves, the policy indicator rate is deemed to be no longer appropriate; the RBF adjusts the rate accordingly.

An increase in the policy indicator rate is referred to as a tightening of monetary policy and is normally undertaken when there are threats that prices may rise much higher than desired. Monetary policy may also be tightened if foreign reserves are under pressure and likely to fall below what is considered adequate. On the other hand, the RBF may reduce the policy indicator rate to ease monetary policy when there is no threat of price increases and when foreign reserves are very healthy.

The exact size of the increases or decreases in the policy indicator rate made by the RBF depends on a number of factors and judgment. What is clear is the direction of change (i.e. to increase or decrease the policy indicator rate). Open market operations are then conducted to either raise or lower the actual interest rate on the 91-day RBF Notes to the level of the policy indicator rate.

Operational Procedures for Open Market Operations

Once a decision is made to sell RBF Notes, market participants are informed via email and fax. In addition, an advertisement is placed in the daily newspaper on the first business day of the week. The advertisement contains the tender and settlement procedures. The RBF's dealing routine is well known to the market.

Apart from the issue and redemption of RBF Notes, there are other factors that influence liquidity. The Financial Markets Department prepares a daily liquidity forecast. This forecast details expected inflows and outflows of funds to and from the system. There are two main types of flows:

(i) Government related transactions; and

(ii) RBF's foreign exchange and domestic transactions.

Tenders for RBF Notes are currently open on Tuesdays and Thursdays between 9.00 am and 11.00 am. Two authorised signatories open the tender box and the bids are sorted by maturity dates and in ascending percentage yield order. The bids are evaluated in relation to the policy indicator rate and the liquidity level. Senior staff of the Financial Markets Department makes the decision on which tenders to accept and reject.

After the allotments have been made, investors are informed over the telephone of the outcome of the tender. Written confirmations of the results are followed up. Successful investors are required to settle their payments on the same day that the tenders are closed. Tender results are also posted on the Bank's website on a weekly basis. Certificates of their investments are provided to investors within 7 days.

Who Bears the Cost of Monetary Policy?

Monetary policy implementation does not come free. There is a cost associated with the sale and purchase of RBF Notes and this is borne by the RBF. This cost is the interest that the RBF has to pay on all the RBF Notes issued.

Coordination with Government and Other Stakeholders

It is important to note that monetary policy is not the only force affecting employment, output and prices. For example, Government's budgetary policies influence the economy through changes in tax and spending programs. Shifts in business and consumer confidence and a variety of other market forces also affect saving and spending plans of businesses and households. For small open economies like us, natural disasters and commodity prices for sugar or gold can cause disruptions in output supply and the economy. Shifts in international trade rules and regulations and in economic policies abroad can also affect our economy.

The RBF recognises that Government's financing policy is fundamentally linked to monetary policy. Monetary and fiscal policy coordination in Fiji is underpinned by the common objective of the RBF and Government of creating the right environment to improve the standard of living for its citizens. Although, the Ministry of Finance and National Planning is largely responsible for formulating and implementing fiscal policy for the nation, at many stages of the policy formulation, input is sought from the Reserve Bank. This harmonisation of policies is enacted in the RBF Act and is effected through a number of committees such as the Macroeconomic and Debt Policy Committees, which is represented by both institutions.

Apart from Government, the RBF has consultative meetings and discussions with major stakeholders such as from the retail, manufacturing, tourism, sugar and mining sectors. These meetings help the RBF to learn how the industries are performing and have a better feel of where the economy is heading. Therefore, in making decisions relating to monetary policy, the RBF ensures that interests of all stakeholders are addressed, making its policy more effective.

How do we Judge the Success of Monetary Policy?

The performance of monetary policy is judged not on the achievement of the policy indicator rate and how it was attained. More importantly, the success of monetary policy is based on the achievement of the two objectives of low inflation and a comfortable level of foreign reserves, which lays the platform for policies that result in improved standard of living for all Fiji's citizens.

In this respect, data reveals that Fiji has had relatively low inflation and foreign reserves has been maintained at comfortable levels.

RESERVE BANK OF FIJI

The great double-hulled, ocean-going canoes (drua) of the ancient Fijians were remarkable craft capable of long voyages. The tagaga (pronounced "tanganga") or masthead, was crucial for holding in place the sails, woven from the leaves of the pandanus tree. It was the tagaga which enabled the navigators to keep their drua sailing towards their destinations.

For the Reserve Bank of Fiji, a logo based on the tagaga masthead, symbolises the Bank's role in contributing towards a sure and steady course for Fiji's economy.