Money Creation in Fiji

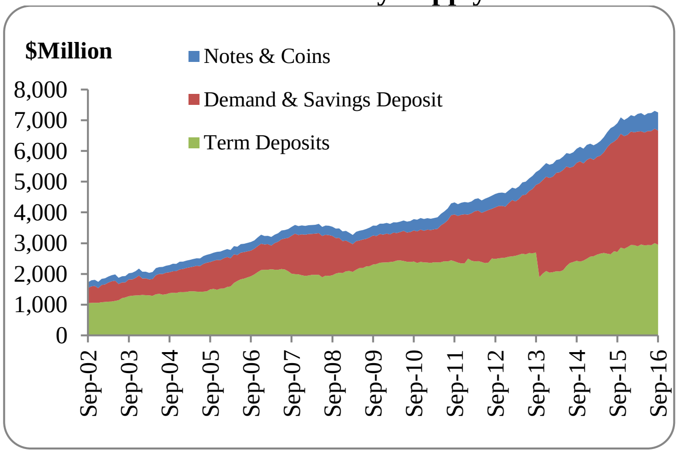
1.0 Introduction

The Reserve Bank of Fiji (RBF) is responsible for printing the country's currency notes and minting its coins as well as ensuring that there is an adequate supply of high quality currency in circulation to meet the demand for payment purposes in the economy. The RBF issues currency to commercial banks for circulation to the public and also redeems any mutilated currency received from banks that are no longer fit for circulation. Over the course of its circulation in the banking system, money *"grows"* in what is termed as the *money multiplier effect*. This article is aimed at helping to understand how the process of money creation works.

2.0 How Does the Money Multiplier Work?

In many economies, a significant portion of money is held as bank deposits. In Fiji, money supply comprises notes and coins circulating in the economy and money placed with commercial banks and licensed credit institutions. Banks in Fiji hold most of the money supply which totalled around $7,381.5 million in September 2016, consisting of notes and coins, demand and savings deposits (58.4%) and term deposits including securities (41.6%). Term deposits are placed with banks for a specific interest rate and a maturity date (Chart 1).

Chart 1: Money Supply



Source: Reserve Bank of Fiji

The money creation process takes place through the creation of deposits at the commercial banks. The example below illustrates this process:

- A $100 salary deposit is made with Bank A. The commercial banks are required by the Reserve Bank to maintain a percent of all deposits collected as statutory reserves deposits (SRD). These SRD balances are held with the RBF as one of its various instruments to conduct monetary policy or as a prudential or safeguard measure in the financial system.

- The RBF has currently set the SRD at 10 percent. Therefore, Bank A deposits $10 (10% of its overall deposits, in this case the $100 you have deposited with Bank A) into its account held at the RBF and lends the $90 to another customer X.

- Customer X takes the loan ($90) and buys goods from Customer Y. Customer Y receives the payment for goods and deposits it into Bank B.

- Bank B allocates 10 percent of the $90 deposited by Customer Y to the required reserves and lends out $81 to Customer Z.

- This cycle continues with different banks and customers until the $100 deposit is transferred to the SRD account at the Reserve Bank or held outside the commercial banks.

Thus, the $100 initially deposited into Bank A leads to the creation of multiple deposits, and the number of times the original deposit has grown is referred to as the money multiplier.

3.0 How is the Money Multiplier Measured?

Money multiplier (m) can be measured as:

$$m = \frac{1 + c}{r + e + c}$$

where:
c is currency to total deposits ratio;
r is SRD to total deposits; and
e is the ratio of excess reserves to total deposits.

This general model shows the determinants of the multiplier as c, r and e.

Using this measurement method, over the past 10 years, on average, each dollar deposited with commercial banks in Fiji has created an additional $4.10. However, in the last five years, the multiplier averaged 3.4 due to a build-up in excess funds of commercial banks held with the Reserve Bank which has not been lent out. Banks normally do not lend the full 90 percent as a small amount is held as Banks Demand Deposits in the event depositors withdraw funds. In addition, banks also invest some of the funds in securities.

4.0 Conclusion

While there are no benchmarks for the size of the money multiplier, for a developing country like Fiji, a relatively high multiplier, which implies higher domestic economic activity, would augur well provided the RBF's primary objectives of macroeconomic stability - in particular an acceptable level of foreign reserves and low inflation - are protected. At the same time, it should be noted that the money multiplier is also affected by other factors including developments in the financial system, changes in consumer habits, economic growth, technological development and increased access to financial services, many of which are difficult to measure and beyond the scope of this article.

Therefore, although commercial banks create money through lending, there are many factors that can either constrain or amplify the amount and extent to which banks can lend. For instance, banks are limited in how much they can lend depending on the extent of borrower risk, the cost of borrowing and the demand for loans. Prudential regulations set by the Central Bank to maintain financial and macroeconomic stability can also restrict banks' activities. In addition, decisions by households and companies, such as repaying existing debt, can also impact on the stock of money. Furthermore, a decline in the amount of money in circulation resulting from individuals deciding to hold less cash in their wallets, allows banks to generate loans from individuals' deposits placed with them and therefore boost money creation.

In summary, most of the money in the economy is created through the commercial banks rather than printing by the Central Bank. As reflected above, the banks create money when they accept deposits from their customers and lend to other customers. The role of the Reserve Bank is to ensure that the process of money creation is consistent with achieving its objectives of maintaining monetary, financial and macroeconomic stability while supporting positive, sustainable and inclusive growth in the economy.