RESERVE BANK OF FIJI ECONOMIC FOCUS

What are Open Market Operations?

Central banks have several instruments that they can use to conduct monetary policy. One of these is interest rate. How does a central bank influence interest rates? Some central banks still use regulation to control interest rates. This direct control is a heavy handed and inefficient way to set interest rates and is common in markets that are not well developed. Many central banks, like the Reserve Bank of Fiji, now use the market to influence interest rates. The process through which the central bank influences rates is called "Open Market Operations" or OMO.

What exactly are OMO? How is it conducted? Why are they necessary and desirable? In this article, we will try to answer these questions in a very simplified way.

What is OMO? Interest rates can be regarded as the cost of money. The price of a commodity depends on how much of that commodity is available for sale. For instance, if dalo is plentiful in the market, the price will tend to decline. The same thing can be said for money. If more money becomes available, the price or interest rates will tend to decline.

The central bank attempts to influence interest rates by controlling the amount of money that is circulating in the financial system. If the central bank wants to influence interest rates upwards it absorbs money from the system and releases money into the system when it wants to influence rates downwards. It absorbs money from the system by selling securities. It releases money into the system by buying back those securities. The buying and selling of these securities is called OMO.

What security is generally used for OMO? Most central banks use government securities to conduct OMO. However, 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 an interest rate, which it believes is consistent with its broader monetary policy objective. This is called the policy indicator rate and it is the desired rate for its 91-day RBF Notes. This rate has recently been raised from 1.25 to 1.75 percent. If the actual 91-day rate is lower than the policy indicator rate, OMO will be conducted to sell RBF Notes (withdraw funds) until the actual rate is in alignment with the policy indicator rate. If the actual rate is higher, OMO is conducted to buy RBF Notes (add funds). Hence, OMO is undertaken when there is a "gap" between the actual 91-day rate and the policy indicator rate.

How does OMO work? OMO works through a bidding or tender system. Each week, the Reserve Bank advertises in the local dailies its intention to sell its Reserve Bank Notes. Commercial banks and other organisations such as FNPF bid for these Notes at a price (interest rate) determined by them. The Reserve Bank will either reject or accept these bids in accordance to its policy direction. Investors are informed of tender results on the same day.

The successful bidder pays the Reserve Bank the amount of Notes they tendered for and, in return, receive a certificate, which is the Reserve Bank Note, saying that the Reserve Bank owes them some money in the future. Successful investors are provided with certificates within 7 days. The Reserve Bank retains this money, so that it does not go back into the economy.

On maturity of these Notes i.e. after 91 days, the holders will surrender them to the Reserve Bank who then repays the money with interest.

Who can participate in OMO? Anyone can participate in OMO. However, given the scale of the operations, it is concentrated at large institutions. The minimum amount to participate in the OMO is $50,000. The major holders are the commercial banks and the FNPF. Companies as well as any other institution or individual are eligible to invest in RBF Notes.

How does OMO influence the economy? As mentioned earlier, the Reserve Bank's OMO influences the movements in short-term interest rates. Over time, the OMO will have flow on effects to other long term interest rates such as the commercial bank's lending and deposit rates. Changes in deposit and lending rates will in turn influence the saving and spending behaviours of households and businesses, which will ultimately affect economic activity. This 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 itself into other interest rates and ultimately to the economy. At the same time the setting of policy interest rate and its transmission to the economy is not a scientific and exact science. A large element of judgement is necessary based on past experience, studies and research.

Finally, in the late eighties, the Reserve Bank decided to abandon interest rate controls and adopted this market-based approach through OMO to implement its monetary policy. In this manner, the actual decision to lend, borrow or save rest with the savers, consumers, investors and financial institutions themselves. The Reserve Bank simply changes the operating conditions. This is a more efficient way to implement policy rather than using legislated controls. These arguments make the OMO an ideal tool for the day-to-day conduct of monetary policy.

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