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RBF Reduces Interest Rate

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Early this week, Reserve Bank of Fiji (RBF) announced a change in its monetary policy. It reduced the Overnight Policy Rate (OPR) from 2.5% to 2%.

It signifies pro-growth, expansionary monetary policy stance. RBF expects reduced rate would lead to growth in bank lending, thereby increasing private sector investment.

The RBF is encouraged by rise in level of foreign reserves at $F1.3 billion at the end of January 2011. This is attributed to record arrival of visitors in 2010, exceeding 600,000 and better export performance by the mining and non-sugar export sectors, all of which contributed to reduction in trade deficit.

That is the reason behind RBF's decision to reduce the OPR to 2%, despite lurking fears of rise in oil price due to unrest in oil producing Arab countries and rise in food prices due to a long drought in China.

What is OPR?

The OPR is similar to the federal funds rate in United States or official cash rates (OCR) in Australia and New Zealand. That is the rate at which commercial banks borrow from each other for overnight loans to meet temporary shortage in funds.

Changes in the benchmark rate alter all other interest rates, including long term borrowing rate affecting investment behaviour.

This benchmark rate is determined by market forces of supply of and demand for loanable funds. If the economy is booming, giving rise to higher demand for bank credit, there will be tightness in the liquidity situation. This will be indicated by rise in the overnight borrowing rate.

If the central bank feels that excess demand for bank credit would lead to inflationary pressures, it can apply brakes. It would then adopt a contractionary stance, by raising benchmark rate by resorting to open market sale of securities for mopping up excess liquidity.

The opposite procedure is followed by the central bank in the event of declining economic activities. The monetary authorities would then lower the benchmark rate, by pumping in more liquidity through open market purchase of securities.

Thus, open market operations (OMO) is known as indirect tool, as distinguished from direct tools such as prescribing a proportion of their liabilities (demand deposits and savings and time deposits) to be kept with central bank.

Fiji's RBF was using the indirect tool since the mid 1980s by issuing its securities known as RBF Notes until 2006. The yield to maturity of 91-day RBF's Note was then the benchmark, known as Policy Indicator Rate (PIR).

Since 2006, there has been no OMO in RBF Notes. Apparently the chief reason is that besides mounting administrative costs, there has been a buildup of liquidity in the system since 2006. In such conditions, there was no need for buying up RBF notes to add to liquidity.

The OMO was resumed to some extent only in May 2010 when RBF also changed the implementation procedure. Since then, RBF announces the benchmark in advance under the new name: OPR. There is no reliance on OMO anymore.

The OPR serves the same purpose as that of PIR. The commercial banks consider change in OPR as the signal for altering their rate structure.

The OPR, which was fixed in May 2010 at 3%, was reduced to 2.5% in late November, 2010. It now stands further reduced to 2% effective from Feb 28.

World Inflation

Central banks the world over are facing the dilemma. In the context of inflationary pressures building up, would an expansionary policy be justified?

Would it not be in conflict with the goal of price stability?

The US central bank Chairman Bernanke is facing division in his Board. The “hawks” are for raising the interest rate to fight inflationary pressures. They are against any more pumping liquidity into the system, known as quantitative easing, as the fed funds rate is already close to zero percent and when food and oil prices are rising.

On the other hand, “the doves” are for an expansionary interest rate policy. They are more concerned with unemployment at 9% and they want to encourage private consumption and investment through cheaper bank credit.

In a persuasive article in New York Times of Feb 26, Professor Christina Romer at University of California at Berkeley and a former Chairwoman of President Obama’s Council of Economic Advisers observed that the real division was not about the acceptable level of inflation, but about its causes. According to her, the dispute is limiting the US central bank’s aid to the economic recovery.

With core inflation at less than 1 percent and with unemployment high at 9%, the “doves” are relatively unconcerned about inflation. Romer argues that in a deflationary situation, inflation is good as it lowers real cost of borrowing further, which would encourage investment.

Last Thursday, European Central Bank (ECB) decided to keep interest rate at 1%,. However, ECB President Jean-Claude Trichet indicated a rate increase in April, as they are “"in a posture of strong vigilance" against rising inflation. Obviously he was referring to "price shocks" due to the sharp rises in commodity prices, including oil.

In developing economies central banks have begun their preemptive steps since the beginning of the year. For example, Brazil, almost following ECB action, raised its key interest rate to 11.75%. In fact, this ant-inflationary measure, from 11.25%, is the second half-point increase in 2011.

Our neighbours

On January 27, New Zealand decided to keep OCR unchanged at 3% for the reason that domestic economic activity was weak. With the Christchurch earthquake rehab measures, there would not be any interest rate increase in the near future.

On March 1, Reserve Bank of Australia (RBA) decided to maintain OCR at 4.75%, despite fears of inflation. The inflation fears are based on stronger-than-expected increase in retail sales and production losses due to bad weather and flooding in Queensland. RBA felt otherwise and did not want to raise the rate. It was confident that other factors would help check prices. These factors include strong exchange rate, decline in wages growth and competition in some key markets.

Will RBF's reduced OPR work?

Central banking is not an exact science, but it is an art of the possible

With improvements in foreign reserves levels, successful measures in terms of reduced trade and current account deficits and ongoing efforts to contain budget deficit, the time has come for Fiji to reduce one more deficit:

That is the critical deficit: the confidence deficit.

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