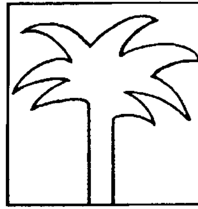


Reserve Bank of Fiji Notes: a new monetary policy instrument

Research Department, Reserve Bank of Fiji

In the aftermath of the 1987 coups the Fiji dollar was twice devalued, in June and October. Stringent exchange control measures were taken to protect the country's foreign exchange reserves under conditions of rapidly eroding confidence, that was manifesting itself in capital flight. On the domestic front there was a tightening of liquidity as demand for bank credit increased, leading to a consequent rise in interest rates. The authorities completely dismantled interest rate controls in July 1987 in order to permit rises in banks' lending rates to contain private sector credit and to discourage the withdrawal of deposits. At the same time, the Reserve Bank issued a guideline to banks to the effect that credit should not exceed the average level of the third quarter of 1987.

Fiji

As a result of the exchange control measures adopted in 1987, foreign exchange reserves were almost back at their end 1986 level in Fiji dollar terms by the end of the year. However, some of this was a product of the devaluations and it was not until end March 1988 that they regained the 1986 level in US dollar terms. During 1988, foreign reserves continued to accumulate as the current account balance went into surplus and a large net inflow was recorded in the capital account, reflecting an increase in confidence in the economy. By the end of 1988 foreign exchange reserves had reached F$322 million, equivalent to approximately six months of imports. With little change in domestic credit, the rise in reserves in 1988 was the main cause of the rise in broad money, that in turn was matched by a very large rise in commercial banks' deposits at the Reserve Bank. At the end of December 1988, the non-interest bearing deposits of the commercial banks reached F$80 million or roughly 10 per cent of their total assets (Chart 1).

The problem

This high level of banks' non-interest earning assets was reflected in a generally lower level of interest rates. The Treasury Bill rate fell from 17.9 per cent at the end of 1987 to 2 per cent at the end of March 1988 and continued to fall so that by the end of December 1988 it was just under 0.5 per cent and in fact reached 0.4 per cent at the end of March 1989 (Chart 2). Commercial banks' interest rates on deposits showed a steady decline during 1988 and at one point large depositors were getting little, if any, return on their funds (Chart 3). Interest rates on promissory notes showed similar declines.

Chart 1 **Foreign reserves and banks' excess liquidity**

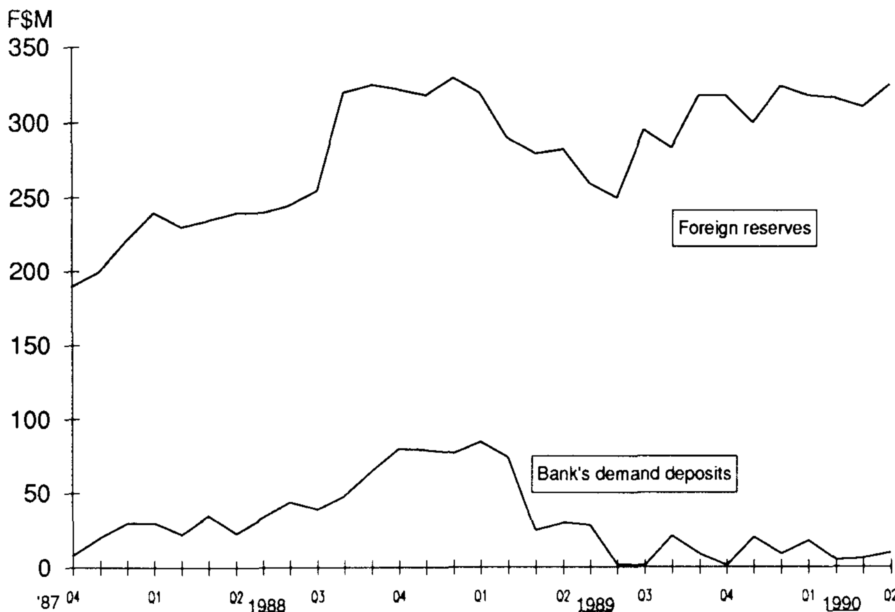
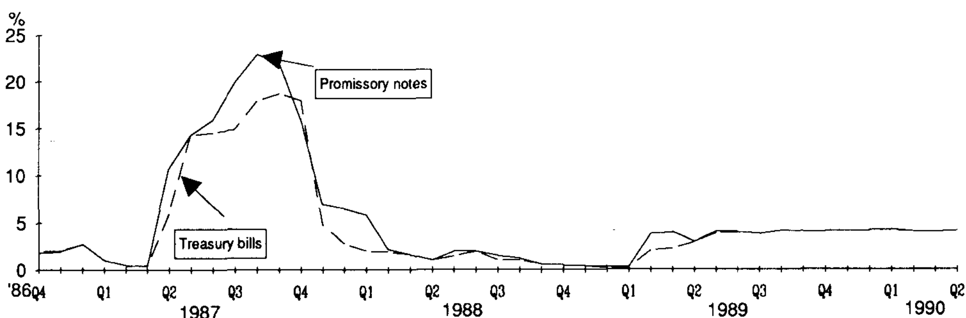


Chart 2 **Short-term interest rates**



Apart from over-depressed interest rates, the excess liquidity had also created a monetary control problem in that it could fund a sudden sharp growth in credit, that in turn could lead to serious pressures on the balance of payments and the level of prices. Furthermore, given that a large part of commercial banks' assets were tied up in non-interest bearing deposits, there was a possible danger to the health of the banking system, arising from a decline in profitability.

Possible solutions

The three possible courses of action open to the Bank were: first, to do nothing but monitor the liquidity situation closely; second, to relax exchange controls and allow residents to hold foreign assets and thereby reduce base money; and third, to sterilize the excess liquidity in some way.

The first course was ruled out on the grounds that the situation was unacceptable in view of the low interest rates and the potential capacity for a dangerous expansion of credit. It was felt that it was too early to relax foreign exchange controls, because that would run against the objective of centralizing the country's foreign reserves in the Reserve Bank and would also involve a loss of income for the Bank and eventually for the government. Therefore it was decided that some form of sterilization of base money was the most appropriate solution.

As the excess liquidity was mainly in the form of banks' interest free demand deposits at the Reserve Bank, one option was to remunerate the holders, either by including the funds as Statutory Reserve Deposits (SRDs), that presently attract an interest of 3.5 per cent, or by directly paying interest on the deposits. In the case of the former this would have meant raising the SRD ratio, which would affect all banks equally and would therefore cause problems for those banks in relatively tight liquidity positions. Furthermore, the time lag in implementing the new ratio would mitigate against prompt action if required. Therefore, this option was rejected on grounds of inflexibility.

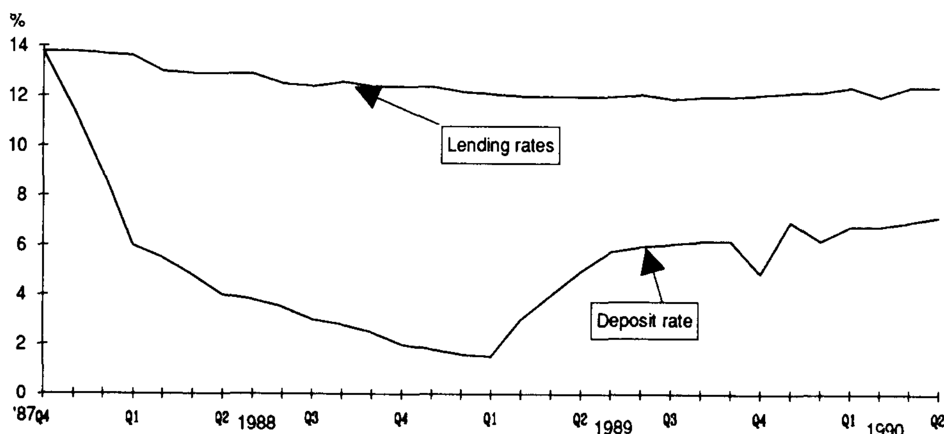
The other alternative of direct remuneration on the banks' excess reserves, would have resolved the interest rate problem provided that the level of remuneration was high enough. But, even so, there would remain the problem of Reserve Bank control over a sudden drawdown arising from a surge in credit demand, unless the deposits were converted into fixed term. If the latter option were to be followed, however, there would remain the disadvantages that (i) they would be available only to banks, (ii) the interest rates would not be market determined and (iii) such deposits would not contribute much to financial market development.

Issue of securities

It was therefore decided that the most logical approach would be through the issuing of securities. This would solve the immediate problem of excess liquidity, provide a flexible monetary policy instrument and contribute to the development of the financial market.

It was decided that the securities used in these operations should have as wide a market as possible to ensure the effectiveness of monetary policy. The fact that government

Chart 3 **Commercial banks' interest rates**



treasury bills fulfil this criterion has led to their being used as monetary policy instruments in many countries. This option was considered but rejected in view of the relatively limited size of the issue of Fiji Government Treasury Bills, (there was at that time a limit of F$25 million), and the Fiji Government's reluctance to make such issues in excess of its needs.

As a result, it was decided that the Reserve Bank would absorb the excess liquidity by issuing its own securities, that would be similar to treasury bills. The effect of issuing these securities, or 'Notes' as they came to be called, was that the Reserve Bank was rechannelling part of the funds it was earning on its foreign exchange reserves to the Note holders. This in effect was the necessary price to be paid for re-establishing monetary control over the system. The longer-run effect was a reduction in Reserve Bank profits and therefore in funds transferred to government.

It is worth noting that, although not widespread, a few central banks around the world issue or have issued their own paper as a means of executing monetary policy, in particular those of Argentina, Indonesia, Republic of Korea, Malaysia, New Zealand and Zimbabwe. The United Kingdom and Canada adopted similar measures in the early 1940s. The three main factors that need to be taken into account when preparing to issue central bank securities are to identify the potential holders; to determine the maturities; and to establish the method of sale of the securities. In addition, arrangements for rediscount or buy back of the securities in the event of an overtightening of liquidity need to be determined.

With regard to potential holders, the aim was that the securities should have as wide a market as possible in order to maximize their effectiveness. Unfortunately, the Reserve Bank Act was unduly restrictive in this respect, allowing it to deal with 'account holders' only. However, subsequently the Act has been amended so that the Notes can now be offered to all market participants. On the question of the appropriate maturity it was decided to offer Notes with maturities of three, six, nine, twelve and twenty-four months. In practice, after the first two issues in March and April of 1989, only maturities up to twelve months have been offered. The selection of public tender as the preferred method of sale was made in order to ensure that the Notes were efficiently allocated and properly priced in accordance with market forces. As the financial market in Fiji was already familiar with the tender procedure, this was an additional advantage.

Issue of Reserve Bank Notes

When the first issue of Notes was made on the 30 March 1989, the foreign exchange reserves had already begun their seasonal decline. Nevertheless, this first issue of F$10 million, together with a fall of F$22.3 million in foreign exchange reserves in April and a further issue of F$20.6 million of Reserve Bank Notes in early April, resulted in a decline of F$50.0 million in the commercial banks' demand deposits at the Reserve Bank from their F$75.1 million level as at the last Wednesday of March 1989. This combination of the seasonal fall in reserves and issues of Reserve Bank Notes reduced banks' demand deposits to F$50.3 million by the end of August 1989. In fact this level was deemed to be too low, having resulted from unexpected declines in the foreign exchange reserves. In fact the Reserve Bank was called on to make advances to the banks, in August and again in December 1989, to ease their tight liquidity positions. Since July 1989, apart from one or two months, in particular September 1989 when an unexpectedly large increase in reserves caused banks' demand deposits to rise to over F$22 million, they have been more or less maintained at close to F$10 million. This is regarded as a comfortable level.

As discussed above, there was a problem at the outset with the legal restriction that prevented the Reserve Bank from offering its Notes to institutions or individuals other than account holders. Until the Reserve Bank Act was amended in September 1989, this problem was partially resolved by allowing non-account holders to purchase Notes from the Sinking Fund.

The total nominal amount of Notes issued in 1989 was F$68.2 million, while F$11.2 million of Notes were redeemed during the year. The nominal amount outstanding was therefore F$57.0 million, with a book value of F$54.9 million (Table 1). Non-bank institutions held F$34.6 million (63 per cent) while the commercial banks held only F$20.3 million (37 per cent) even though their demand deposits at the Reserve Bank at that date amounted to F$18.4 million (Chart 4). However, if account is taken of the F$6.3 million in Reserve Bank advances to the banks at the end of 1989, commercial banks' free funds at the Reserve Bank amounted to F$12.1 million. This situation demonstrates the variation in liquidity between the banks.

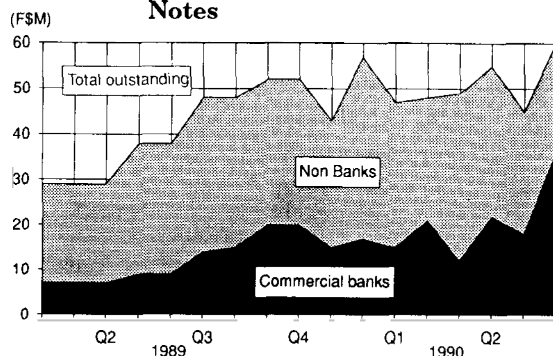
Table 1 **Holdings of Reserve Bank of Fiji Notes** (F$m)[a]

	Total outstanding	Held by commercial banks	Non-banks
1989			
April	29.1	6.6	22.5
May	29.1	6.6	22.5
June	29.1	6.6	22.5
July	41.1	9.2	31.9
August	41.1	9.2	31.9
September	50.9	13.1	37.8
October	49.8	15.3	34.5
November	54.7	20.3	34.4
December	54.9	20.3	34.6
1990			
January	45.1	14.7	30.4
February	58.8	18.7	40.1
March	46.6	15.2	31.4
April	47.3	21.1	26.2
May	49.3	13.1	36.2
June	57.5	21.6	35.9
July	47.0	17.8	29.2
August	61.2	36.0	25.2

[a] As of the last Wednesday until November 1989 and the last day of the month thereafter.
Source: Reserve Bank of Fiji records.

The effect of the issue of Reserve Bank Notes on the liquidity situation can be clearly seen if the situation at the end of 1988, with gross foreign reserves of the Reserve Bank standing at F$322.5 million and the level of banks' free deposits at F$74.5 million, is compared with that at the end of 1989 when gross foreign reserves were slightly lower at F$315.3 million and bank deposits stood at F$18.4 million or a net F$12.1 million after deduction of advances. The difference between the level of banks' free demand deposits at the Reserve Bank at the end of 1988 and that at the end of 1989 (F$56.1 million) is almost identical to the amount of Notes outstanding at the latter date.

Chart 4 **Holdings of Reserve Bank of Fiji Notes**



Effect of interest rates

In the case of Treasury Bills, the abnormally high rates at the end of 1987, reflecting the tight liquidity situation, fell dramatically in the first quarter of 1988 and continued falling to abnormally low levels during the next twelve months. From the low point of 0.4 per cent at end March 1989, the Treasury Bill rate moved up sharply in the second quarter of 1989, it reached over 4.0 per cent by the end of the year, and remained over that level during the first half of 1990. A similar trend can be observed in the commercial banks' deposit rates that also reached a low point at the end of March 1989 and have since risen steadily through the middle of 1990 narrowing the gap between lending and deposits rates to more normal levels. By re-establishing realistic levels of interest rates the issue of Reserve Bank Notes has contributed to the development of the financial market in Fiji; this was one of the aims behind the decision to resolve the excess liquidity problem through the issue of securities.

Establishment of repurchase agreements

A new development in the Reserve Bank's money market operations with commercial banks in 1989 was the introduction of Repurchase Agreements. Under this facility the banks could obtain short-term funding (currently for one month) from the Reserve Bank for liquidity purposes. The facility enables banks to 'sell' to the Reserve Bank of Fiji certain specified securities (in particular Notes) to the amount of the funding required. At the same time the banks agree to repurchase the same securities from the Reserve Bank at a specified date, and at a mutually agreed price. Four repurchase transactions involving Reserve Bank Notes, with a total nominal value of F$7.4 million, were arranged from October 1989, when the facility was first put in place, to the end of the year.

This facility was established to enable the system to be fine-tuned in the event of an unforeseen tightening in the liquidity position of one or more banks. The repurchase agreement differs from the normal central bank rediscount facility, in that by its nature it is only providing temporary assistance, in view of the obligation of the borrower under the agreement to buy back the security. In this way, it is in the nature of an advance against collateral with a fixed repayment date. This facility is similar to a Bank of England

Advance secured by collateral and a US Federal Reserve System repurchase agreement.

Conclusion

A review of the developments in the main monetary aggregates from the end of 1987 shows that the rise in broad money (M3) in 1988 was more than accounted for by the rise in net foreign assets with domestic credit actually declining. The effect of this situation was of course the large rise in commercial banks' deposits at the Reserve Bank, as all foreign assets had to be sold to the Reserve Bank. In 1989, however, the situation was reversed with the strong rise in domestic credit more than accounting for the rise in broad money. Much of the increase in credit was, in fact, related to the financing of imports, and hence the minimal rise in net foreign assets during the year. A further limitation on the growth in broad money was of course the issue of Reserve Bank Notes outside the banking system that amounted to some F$35 million at the end of 1989. Thus, the new monetary instrument had an impact on the country's money supply.

During the first six months of 1990, the normal seasonal fall in foreign reserves was minimal, with the growth in broad money largely reflecting the increase in domestic credit. However, a strong rise in reserves is predicted for the rest of the year with its consequent effect on the money supply, so that it is likely that further increases in Notes will be needed to absorb the expected increase in liquidity. It is encouraging to note that although the stimulus to issue Notes arose from the high level of free demand deposits that the banks held at the Reserve Bank, over 60 per cent of the Notes were held outside the banks as at the end of June 1990 (Chart 4). This situation augurs well for the development of the financial market and suggests that the Reserve Bank Note has become widely accepted as an investment. In the Reserve Bank, it is now viewed as the main active monetary policy instrument. Decisions are made regularly on the amounts needed to be issued or redeemed to maintain monetary stability and to ensure that the liquidity situation is kept under control.

In this respect, the issue and redemption of Notes is similar to traditional open market operations except that the Bank's own securities rather than government and other obligations are the operational instruments. The Bank has the same freedom to issue securities as a traditional open market sale; it has somewhat less freedom to determine redemption than traditional purchases of debt.