CENTRAL BANK OF SAMOA

Monetary Policy in a Liberalized Financial System

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INTRODUCTION

The Government has been engaged in a wide-ranging economic reform program in recent years and commencing in January 1998 this program was extended to the financial sector. The financial sector liberalisation, as the financial sector reform program is known, commenced with the removal of direct controls over the banking system and the introduction of tenders of Central Bank securities.

The removal of the direct controls has meant a change to the way that the Central Bank implements monetary policy. This pamphlet explains how monetary policy will be implemented in a liberalized environment, contrasting it with the methods used before the liberalization, as well as giving some insight into how the monetary policy implementation will develop as the benefits of the liberalization take hold.

Q. WHAT IS MONETARY POLICY INTENDED TO DO?

A. Money is crucial to the workings of a market economy. In simple terms, monetary policy is directed at achieving the right amount of money in the economy to enable goods and services to be produced and distributed throughout the economy. It works by influencing the amount of money that is available, or which can be created through increases in bank lending, as well as the cost of money - the interest rate.

If the rate of credit growth or money supply growth is too high, then there will be too much spending in the economy relative to the amount of goods and services available to the economy. This is known as excess demand in the economy. Too much money will be chasing the few goods and services that are available. If this happens, inflation will be too high and the country ' s foreign reserves will decrease with the increased demand for imports. In this type of situation, monetary policy will be directed at reducing total spending in the economy in order to bring down inflation and slow down the growth in imports to protect the country ' s foreign reserves.

On the other hand, the authorities have to ensure that there is not too little money in the economy. If this happens, production and employment will be lower than what could be the case, allowing for the need to control inflation and protect foreign reserves.

These comments indicate that there is a close connection between monetary policy and exchange rate policy. If the price of foreign goods is too low then demand for foreign goods and hence total demand will be too high. Exchange rate policy has a very important role to play in maintaining the competitiveness of Samoan exports but it also has a role in complementing monetary policy to moderate excess demand in the economy.

Q. HOW ARE THE SECURITIES ISSUED?

A. Prior to the liberalisation, the Central Bank relied on a number of direct controls. It controlled the price of money through interest rate regulations, which stipulated a minimum deposit rate and a maximum lending rate. It also influenced growth in the money supply by placing a ceiling on the amount of credit banks could extend, and by requiring banks to maintain liquid assets equal to 25 percent of their deposits.

Q. MONETARY POLICY IN A LIBERALIZED FINANCIAL SYSTEM?

A. The liberalization saw the removal of the interest rate controls and a relaxation of the credit ceiling, but this does not mean that the Central Bank has lost the ability to influence the money supply and inflation. Rather, it will now use different methods. In the future, the Central Bank will operate in the marketplace alongside the other financial institutions to influence the funds available in these markets. Greater use will be made of market-based methods such as tenders of Central Bank securities and, at a later stage, open market operations.
By operating in this way, the Central Bank achieves the financial conditions that are consistent with its inflation and international reserves objectives, but the financial institutions will be free to attract and allocate funds at the appropriate market-based interest rates.

Q. THE TRANSITION?

A. Clearly, it is a major change to move away from direct controls and the financial system cannot be expected to adjust to this change overnight. The Central Bank and other financial institutions will be operating in a new environment and it will take time for all parties to become familiar with the new arrangements. To help with the transition, and to underpin monetary control, the liquid asset requirement will be gradually phased out over eighteen months and completely removed by mid 1999. During this time the Central Bank will give greater emphasis to statutory deposit ratios as it develops it market-based methods.

Q. A MARKET-BASED MONETARY POLICY?

A. The liberalisation of the financial sector will allow financial institutions to be more responsive in setting interest rates and meeting the demand for credit. As a result, the price of money will now be the primary determinant of how the money is used within the economy. There will be a marketplace for money just as there is a marketplace for all types of goods and services. In these markets, prices change when the availability of the item changes. The price decides the amount available to those that are willing to pay that price.

The same thing will happen with money. As the availability changes or the demand for loans changes, the price of money - the interest rate - changes. This is the most efficient way of allocating the available funds to the many users competing for those funds.

In implementing a market-based monetary policy, the Central Bank will be taking some action to influence the supply of money in the financial marketplace. This will have an impact on the interest rate, which, in turn, will have an impact on the amount of spending in the economy. If there is excess demand in the economy the Central Bank will be trying to increase the price of money to reduce spending so that inflation will not be too high and foreign reserves will be adequate. Similarly, the Central Bank can take action to reduce the price of money, if this would not cause any inflationary problems or a rundown in foreign reserves.

Q. WHAT ROLE WILL THE TENDERS OF CENTRAL BANK SECURITIES PLAY?

A. When the Central Bank issues securities, it is trying to slow down money and credit growth by withdrawing money from banks and the public. For example, if a commercial bank buys a Central Bank security, then its deposits with the Central Bank will be lower. The funds available for lending are lower and this helps avoid the situation where there might be too much spending in the economy with undesirable consequences for inflation and foreign reserves. Interest rates adjust accordingly to ensure that there is still a balance between the availability of funds and the demand for these funds.

A tender process has been chosen because this is the best way of promoting competition for the securities, and the more competition the lower the interest costs that the Central Bank will face in issuing the securities. A competitive market for central bank securities coupled with the removal of interest rate controls will lead to a much more competitive financial sector overall.

In order to foster greater competition in the financial sector, those that want to buy the securities must be able to bid the yield - the effective interest rate - they want to receive. The Central Bank wants to avoid the situation where it sets the interest rate because that will not force the financial institutions to think about their interest rate structures. These interest rate structures must be flexible to encourage the financial system to allocate the available funds in the best way.

Q. THE FUTURE – MAKING GREATER USE OF OPEN MARKET OPERATIONS

A. The immediate objective in tendering Central Bank securities is to reduce the level of deposits that banks have with the Central Bank because if these were lent out at this time there would be too much spending in the economy.

Once these excess deposits have been removed, the Central Bank can then concentrate on managing the liquidity of the financial system in a way that prevents a big build-up in bank deposits at the Central Bank, or conversely, avoids the situation where banks do not have deposits. In other words, the Central Bank will be smoothing out bank liquidity.

This will require the Central Bank to conduct monetary operations in addition to the main tenders. There will be times when the Central Bank may want to inject liquidity into the financial system. It could do this by buying back securities it has previously issued - buying on the open market -or by making very short-term secured loans to the banks. There may also be times when it needs to withdraw liquidity but does not want to wait until the next tender. In this case, it could offer to sell smaller amounts of Central Bank securities, but as with the tender, these securities would be offered on a competitive basis.

MORE INFORMATION

If you require more information about policy issues related to the liberalization of the Samoan financial sector, please contact:

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