CENTRAL BANK OF SAMOA

Financial Sector Liberalization

Private Bag, Apia, Samoa Ph: (685) 34100; Fax: (685) 24058 Email: centralbank@cbs.gov.ws URL: www.cbs.gov.ws

INTRODUCTION

In recent years, the Government has been engaged in a wide-ranging economic reform program. For some time, the Government has indicated that these reforms would be extended to the financial sector and the broad nature of the proposed financial sector reforms had been outlined in the Government's Statement of Economic Strategy - the SES. Financial sector reform, which is also referred to as financial sector liberalisation, commenced with an initial package of reforms in January 1998. This pamphlet discusses these initial reforms as well as giving an overview of the types of reforms that can be expected in the future.

AN OVERVIEW OF THE FINANCIAL SECTOR LIBERALIZATION

A liberalisation is a 'freeing-up' of some sort. There is a removal of some type of restriction. A financial sector liberalisation then is the removal of Central Bank restrictions that were applied to the financial sector.

Under this liberalisation program, the Central Bank will gradually remove the direct controls that have been imposed on the financial sector. In future, there will be greater reliance on market mechanisms, as is the case in the other sectors of the economy

Q. WHAT RESTRICTIONS HAS THE FINANCIAL SECTOR BEEN OPERATING UNDER?

A. In the past, the Central Bank has applied several types of restrictions on the Samoan financial system, as well as maintaining a system of foreign exchange controls. The initial package of reforms focussed on the domestic transactions of the financial sector. But, the Central Bank has been progressively relaxing exchange controls for some time now and additional reforms affecting foreign exchange transactions will be implemented throughout 1998 and 1999.

Banks have been subject to interest rate controls which meant that they had to offer at least 4.5 percent per annum on deposits and that they could not charge more than 12 percent per annum on loans. The Central Bank also placed a ceiling, or upper limit, on the amount of credit that banks could extend.

An additional restriction on banks was the requirement to hold liquid assets - assets which can be quickly converted to cash or used in a similar way to cash - equivalent to 25 percent of their deposits so that they could readily meet their obligations. This requirement is known as the liquid asset requirement, commonly referred to as LAR. Twenty-five percent of the deposits held under LAR were held in a special account known as statutory reserve deposit or SRD.

Q. THE INITIAL REFORMS

A. Effective 12 January 1998, the Central Bank removed the interest rate controls and relaxed the credit ceiling. Banks are now free to set their own deposit and lending rates and they can, in addition, decide how much credit they want to extend.

Changes were also made to the LAR and SRD. The LAR ratio has been reduced from 25 percent to 20 percent effective end January 1998 and it (LAR ratio) will be completely phased out by the end 1999. Also effective end January 1998, the SRD is no longer linked to the LAR and has been initially set at 5 percent of total deposits.

Q. WHY DID THE CENTRAL BANK REMOVE THE CONTROLS?

A. There were two main reasons for removing the controls. Firstly, the controls on banks had disadvantaged the banks relative to the nonbanks, particularly the larger nonbanks such as the National Provident Fund and the Development Bank of Samoa. The playing field was not level, so to speak. Banks were in a position to contribute more financial services to businesses and the public but were discouraged from doing so, as a result of the prevailing controls.

The second reason for removing the controls was to facilitate private sector development. The controls had done their job in the past but the time had come to move on, in order to keep up with ongoing development in the financial systems world wide. Two of the objectives of the Government's economic reform program have been to stimulate private sector activity and to promote investment in the Samoan economy. For this to happen, the financial sector needs to be more responsive so that it can attract more funds and allocate these funds to competing uses.

This resource allocation role played by the financial system is fundamental to the working of a market economy. The better the job the financial system does in this role the stronger the economy.

To be more responsive, banks needed to be able to make their own decisions on the amount of credit to extend and the interest rate at which loans would be made and which would be offered to attract deposits. There are different risks associated with lending to different sectors and different borrowers. Banks need to be able to vary their lending rates according to these risks. A continuation of the interest rate controls and credit ceilings have discouraged the banks from meeting the demand for credit and offering interest rates that were consistent with this demand.

Allowing the financial system to be more responsive in setting interest rates and meeting the demand for credit means that the Central Bank can also change the way it implements monetary policy. Greater use can now be made of market-based methods (such as tenders of Central Bank securities) and, at a later stage, open market operations.

Also, having to comply with the liquidity ratios set by the Central Bank from time to time means that banks do not have the full use of their customer deposits. Furthermore, the banks only get a low interest rate on these deposits and, in some cases, no interest at all. Compare this with the situation faced by nonbanks. There is no statutory requirement for them to keep a percentage of their deposits at the Central Bank which means that they can lend out all of their funds, and are not disadvantaged by the low interest rate paid by the Central Bank

Q. REMOVING FOREIGN EXCHANGE RESTRICTIONS?

A. The Central Bank has been relaxing exchange control regulations for some time with the latest change effective from 5 January 1998. These changes have been aimed at making it easier to make import payments. The restrictions that remain are mainly on financial transactions such as borrowing and lending and investments in foreign securities and equities. The Central Bank is committed to removing these remaining restrictions and as a first step will be undertaking a major review later in 1998 on how best to do this.

The Government has also recently removed the one percent levy on purchases of foreign exchange. This positive move by Government should further encourage members of the public to use banks for foreign exchange transactions.

Q. WHAT WILL BE THE BENEFITS OF THE LIBERLZATION

A. The liberalisation will result in more funds flowing through the financial system. Banks will be free to compete for funds and can offer different interest rates to attract the funds they need to meet borrower demand. Until now, the controls on the financial sector have constrained the availability of funds and the use to which these funds can be put. Liberalisation will allow the best use of the available funds to be determined in a marketplace.

The emergence of market signals in our financial markets will be one of the most important benefits of the liberalisation. There is a marketplace for all types of goods and services and most people transact in markets without thinking about it. In these markets, prices guide the allocation or the use of the good or service. Think about the Fugalei market. Prices change at different times of the year because the availability of the items changes. The price rations the amount available to those that are willing to pay that price. Relying on the market and the market price is the most efficient way of allocating that item within the economy. The same principles apply to financial markets. The price in this case is the interest rate and it is the interest rate that allocates the available funds to the competing users in the most efficient way.

Q. WHAT CHANGES WILL THE PUBLIC NOTICE AFTER THE LIBERALIZATION?

A. The most noticeable impacts of the liberalisation will be increased access to credit and borrowers will no longer be all charged the same interest rate. Banks will no longer be telling customers that a loan application cannot be considered because of credit ceilings imposed by the Central Bank. Financial institutions will also now be pricing their loans according to how they assess the risks of individual borrowers and individual projects. Better risk management will result in stronger financial institutions but, at the same time, will still allow these institutions to lend on development projects that carry some added risks.

The Central Bank fully expects the liberalisation to encourage and promote private sector activity, to the benefit of the economy as a whole.

Q. HOW WILL THE CENTRAL BANK OF SAMOA CONTROL THE MONEY SUPPLY AND INFLATION IF IT DOES NOT HAVE DIRECT CONTROL OVER INTEREST RATES AND CREDIT?

A. The liberalisation does not mean that the Central Bank loses its ability to influence the money supply and inflation. Rather, it will use different methods. The Central Bank will operate in the marketplace alongside the other financial institutions to influence the funds available in these markets, for example, through the tender and repurchase of its own securities. 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 prevailing interest rates.