

The “Repo” Rate and You...

Have you ever wondered what the big excitement was over the “Repo” Rate? Why all the special announcements and specific dates set for these announcements? Maybe you thought that it was some big finance term that did not have any impact on you and as such never really paid it much attention. Well, in this article I will explain the main purpose of the “Repo” Rate and show you how changes in the rate can have such a rippling effect that it eventually does have some impact on you and me!

The last announcement concerning the “Repo” Rate was on August 23, 2007 when the Central Bank indicated that it had decided to maintain the rate at 8.0 per cent while keeping monetary conditions under close review. The next announcement is scheduled for September 21, 2007. For us to appreciate the significance of these announcements we need to firstly understand the significance of the “Repo” Rate.

The “Repo” Rate is an interest rate that the Central Bank of Trinidad and Tobago introduced in May 2002 to use as the rate at which commercial banks can borrow overnight financing from the Central Bank when they cannot meet their liquidity requirements. This occurs since all commercial banks are required by law to hold a ratio of their deposits as reserves in the Central Bank. Occasionally, commercial banks may not be able to meet the reserve requirement and may therefore opt to borrow from the Central Bank.

The question is: What causes the movement in the “Repo” Rate? In instances of inflationary pressure the Central Bank may seek to increase the “Repo” Rate in order to control inflation. By increasing the Rate, the Central Bank is in effect trying to curb spending by raising the cost of borrowing and reducing the purchasing power of consumers. Increasing interest rates can have either a positive or negative impact-economic indicators show us the outcome. For instance, if interest rates are increased and ****Gross Domestic Product (GDP)* falls, then this might be a sign that the economy is slowing and possibly going into a recession, which is not a good sign. However, if interest rates are increased and the ****Consumer Price Index (CPI)* decreases, this would be more of a positive signal for the economy since this means that prices are falling and thus inflation is on the decline.

When the Central Bank changes the “Repo” Rate this has the effect of changing the cost of money for the commercial bank which in turn is likely to be passed on to the consumer in either a higher or lower cost of borrowing, depending on the movement. In other words, when the Central Bank increases the “Repo” Rate, this makes it more expensive for the commercial bank to borrow funds and as such this is passed on to you and me in the form of higher interest rates on loans.

You may have noticed that when the “Repo” Rate is increased there are announcements that the “Prime” Rate also increased. The “Prime” Rate is the rate that commercial banks charge their most credit-worthy customers, which are generally large corporations. Higher interest rates tend to slow business growth and consumer spending. The reverse is true, when interest rates are low- capital is easier to acquire. The more money we have, it

is only natural for us to spend more, and this has a spiraling effect of increasing the demand for goods and services which in turn increases the level of corporate profits.

This brings me to my next point of how changes in the “Repo” Rate can also have an impact on the stock market. As stated above, a corporation’s profits can be either positively or negatively affected depending on the direction of the change in the “Repo” Rate. Consequently, higher earnings for a company mean higher Earnings Per Share (EPS), while lower earnings results in a lower EPS. Increases in EPS translate into higher share prices and thus higher returns for investors, while decreases in EPS negatively impacts share prices and investor returns.

To summarize: changes in the “Repo” Rate have the effect of changing the Prime Lending Rate which affects the cost at which you can borrow money. This in turn, affects your spending power and translates into higher or lower Corporation Profits thereby increasing or decreasing Earnings Per Share (EPS). This inevitably affects future share prices and investor returns. Additionally, it is important to note that while these effects may not be seen immediately, they do occur over the medium to long term.

In the United States of America, the equivalent of the “Repo” Rate is the Discount Rate. Thus, the Discount Rate is the rate at which a Federal Reserve Bank charges the commercial banks to borrow short term funds. However, unlike the local market, this rate has no real effect on the rest of the economy. The rate in the US which has more of a direct impact on the economy is the Federal Funds Rate, often referred to as the Fed Funds Rate. This rate is the interest rate at which a depository institution or commercial bank lends immediately available funds to another depository institution overnight. In Trinidad and Tobago this rate is known as the Inter-bank Rate and it is determined through the forces of demand and supply of money.

*****Consumer Price Index (CPI)** - A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

*****Gross Domestic Product (GDP)** - The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory. GDP is commonly used as an indicator of the economic health of a country, as well as to gauge a country's standard of living.

Definitions sourced at www.investopedia.com

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