Interest Rates and the Fiji Economy

The subject of interest rates has been a topical issue lately. This article will explain what interest rate is; how it is used by the Reserve Bank of Fiji for monetary policy purposes; the reasons for the recent interest rate increases and how interest rates in Fiji compare with other countries.

Money, like any other commodity has a price to it. The price of money is the interest rate. If you are a saver, interest is the return that you receive when you invest your money in bank deposits. Conversely, if you are the borrower, interest is the cost of borrowing that money.

Therefore, the rate of interest affects peoples' decisions on whether to save or spend their money. Let us take the situation when interest rates rise. People will save more, because returns are higher, and they will borrow less because funds are expensive.

Likewise, the reverse is also true. If interest rates are low, people will borrow more because money is cheaper and save less because the return is lower.

The relationship between interest rate, saving and borrowing is therefore straight forward. There is also an important link between savings, borrowing and spending. When your income is the same, and if you save more, you will obviously have to spend less. At the same time, you can borrow to spend on something. If you borrow less, you will spend less. There is therefore a direct relationship between saving, borrowing and spending.

The aggregate amount of money that we spend as a nation determines the size of the economy. Therefore, interest rates influence the economy through the decisions of savers and borrowers. This link from interest rate to spending and economic growth is what a central bank relies upon when it uses interest rate as a policy instrument.

The degree of influence that interest rates have on spending and the economy and the time it take for rates to affect them varies from country to country largely depending on the level of development of its financial system and capital markets.

Interest rate is the major policy instrument of central banks like the Reserve Bank of Fiji (RBF) to achieve their economic objectives. The central bank influences interest rate by controlling the liquidity in the banking system. Liquidity is the free money commercial banks' have that are available for lending. If this free money increases, the more the commercial banks have available for lending and they will lower their lending rate to attract more borrowers. Therefore, if the central bank wishes to influence interest rates upwards it reduces liquidity and vice versa. The central bank sends out a signal to commercial banks of which direction it wants interest rates to move.

We have covered the link between interest rate, borrowing and spending and the economy. There is also an important link between spending and imports. In Fiji, a lot of our goods are imported because we do not make them. Therefore, more spending is directly translated to more imports.

To pay for these imports, we need foreign exchange as no one abroad would accept payment in Fiji dollar. Hence, we need foreign currency to buy overseas made things such as computers for our schools, educational institutions and businesses, medicines for our hospitals, building materials for our houses, vehicles for transportation, fuel for machines to run and many other things that have become necessary in our daily lives but are not produced locally. We earn these valuable foreign currencies through selling our exports overseas.

Imports have been rising since 2001. This would have been fine if our exports have been performing well to earn us the foreign exchange we need to pay for our imports. Unfortunately, exports have been dismal. The lower interest rates prevailing after 2000 was a deliberate measure to promote spending and restore economic growth after the 2000 crisis. But because of the poor export performance, this higher spending has led to higher imports which have been eroding our pool of foreign exchange.

It is the Reserve Bank's mandate to maintain an adequate pool of foreign reserves for Fiji. Therefore, the Reserve Bank has to use the instruments it has to protect this mandate. So the Reserve Bank started raising interest rates since 2004. This, over time, will discourage borrowing, slowdown spending, slowdown imports and help reduce the pressure on foreign reserves. At the same time the Reserve Bank clearly signaled the need to do something to raise our exports.

High interest rates affects all those who save or spend and that includes everyone, institutions, businesses and individuals. Savers like the Fiji National Provident Fund will be happy with the rising level of interest rates. On the other hand, existing borrowers will not be happy as their interest payments will rise. New borrowers will be discouraged to borrow money. Investment may be put on hold. There are advantages and disadvantages of higher interest rates.

However, the country should not loose sight that high interest rates are there to help protect our foreign reserves. If our pool of foreign reserves is depleted we cannot pay for our imports or service any obligations offshore. The economy will virtually come to a halt. Jobs will be lost. Investors will not invest. This will create untold social and economic hardships. Ultimately, Fiji will have to seek help from overseas partners to give us foreign exchange. These partners will demand difficult and painful actions that Fiji should take before they can help us. All in all, everyone will be worse off than where we are now. This is not hypothetical. It has actually happened to some countries in the world. Our best option is to avoid this happening altogether by taking the tough decisions and making sacrifices now.

When interest rates rise, there are ways that companies and individuals can mitigate its effects on their financial positions. We can rearrange our expenses. We can sacrifice unnecessary spending. We can cut cost. We can plant more food.

Fiji is not the only country that raises interest rates. Almost all other countries in the world use interest rates as a policy tool. Individuals and companies in these countries go through these adjustments when interest rates rise.

However, the Reserve Bank is mindful of the present combination of high interest rates and low economic growth. In order to address this, the Reserve Bank has advised the commercial banks and credit institutions to continue to put priority to lending for investment, first home owners, exports and small businesses.

Many central banks around the world have raised interest rates some three or four times in a year. When we compare the interest rates in Fiji with countries like Australia and New Zealand as well as some of our Pacific Island neighbors it clearly reveals that interest rates are relatively low in Fiji (see Table 1). For example the lending rate in New Zealand is 12.24 percent, in Papua New Guinea 10.16 percent and Samoa 12.23 percent. This compares with 8.28 percent in Fiji. While these are weighted average lending rates and the rates will differ for individual borrowers they are the best gauge of the general level of interest rates between countries.

Table 1: Selected Interest Rates

	Central Bank Rate			Lending Rate		
	Dec 2005	**Dec 2006**	**Jan 2007**	**Dec 2005**	**Dec 2006**	**Jan 2007**
New Zealand	7.25	7.25	7.25	11.53	12.25	12.24
Australia	5.50	6.25	6.25	9.06	9.41	9.85
Papua New Guinea	6.00	6.00	6.00	11.47	10.57	10.16
Samoa	2.14	5.25	4.21	11.50	12.14	12.23
Fiji	2.25	4.25	4.25	6.63	7.89	8.28

Source: International Financial Statistics & Various Central Bank's Publications

The above comparison of interest rates throws up two interesting issues. First, all the countries that we have included in the comparison are performing better than Fiji including Samoa and Papua New Guinea. Yet lending rates are higher than Fiji. It implies that there are other factors that are important for investment and growth than interest rates alone. Second and perhaps more pertinent, these countries do not face the degree of economic challenges that we currently face in Fiji. For instance, Papua New Guinea and Samoa have better levels of foreign reserves in months of imports than Fiji has, yet their lending rates are higher.

It is therefore critical that we continue to safeguard the financial stability of our country in light of the pressing challenges that we face. During the last four years, the Reserve Bank has been progressively trying to do all it can through the controls available to it to safeguard this stability. One thing must be made clear though. The consequences of inaction or insufficient action would be much more devastating than having to deal with the high interest rates that we face now.

Reserve Bank of Fiji