RESERVE BANK OF FIJI ECONOMIC FOCUS

How Do Interest Rates Affect the Economy?

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. This interest is the price that commercial banks pay you for using your funds to lend to individuals or businesses.

Conversely, if you are the borrower, interest is the extra amount that you have to repay commercial banks for the money that you borrowed from them. That is, you borrowed money from banks or used commercial banks' funds for your own expenses, so what you repay banks is the amount of money you borrowed (which is called principal) plus some extra money (which is the interest).

The rate of interest that is paid or charged by banks affects peoples' decisions on whether to save or spend their money.

When interest rates are high people usually save more of their money. This makes sense. By giving up spending today, they can increase their spending by much more in the future.

Also, at high interest rates, people usually borrow less as borrowing costly funds today will mean giving up a lot of spending in the future when the loans have to be repaid.

Businesses think the same way. If interest rates are high, they will be reluctant to borrow, as this will raise their cost of doing business.

The decisions of savers and borrowers affect the economy in the same way. If interest rates are high, people will spend less. More money will go into saving and less will be borrowed for spending on consumption and investment goods.

If interest rates are low, the behaviour is reversed. Individuals and businesses save less, because returns are lower, and they borrow more since the funds are cheaper. In this case, there is less saving and more spending on consumption and investment.

At certain times it is good to have low interest rates, even deposit rates. When the economy is weak, low interest rates encourage people to spend. Therefore they buy more goods & services, which helps businesses to increase their sales, as well as to produce more. Such developments help strengthen the economy further.

At other times it is good to have high interest rates, even lending rates. If the economy is growing too strongly, there will be inflation. This will raise our import bill and lower our foreign reserves level. In this case it is good to have higher interest rates so that people will spend less. If inflation gets out of control and reserves fall, interest rates would have to go up anyway, and probably by more than they would have needed to otherwise.

On average, it is good for savings interest rates to be high as this encourages people to put some money away for the future and provide funds for investment. However, interest rates should not be too high, as this will cause lending rates to rise, which will discourage borrowing and investment.

A balance between the interests of savers and borrowers is therefore necessary, as it will encourage the flow of funds from savers to investors.

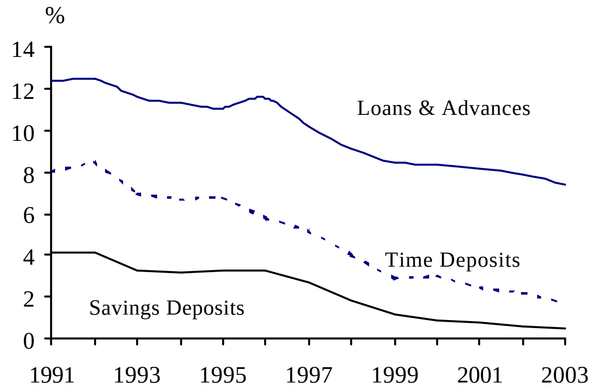
The Reserve Bank of Fiji's (RBF) monetary policy stance influences the direction of interest rate in Fiji. The RBF influences the level of interest rates in the banking system by controlling the level of short-term interest rates. It does this through a process called open market operations (OMO). Under OMO, the RBF sells its security, called RBF Notes, when it wishes to raise interest rates.

Alternatively, when it wishes to reduce interest rates, it will buy back some RBF Notes outstanding, which adds liquidity into the banking system. So, by purchasing or selling RBF Notes, the RBF adds or withdraws funds in the market, which affects short-term interest rates.

The RBF uses its indicator rate to signal its policy intentions to market participants like commercial banks. The indicator rate is currently the RBF Notes 91 day rate. Depending on the state of the economy and its impact on prices, the RBF decides on the appropriate interest rate. If the economy is growing too fast, such that inflation begins to rise, the Reserve Bank will raise its indicator rate. On the other hand, if the economy is weak the Reserve Bank will reduce the indicator rate. The actions of the Reserve Bank on the indicator rate will have flow on effects to other interest rates such as the commercial bank lending and deposit rates.

It is important to note that the RBF does not set interest rates charged by commercial banks. It merely uses its operations in the market to influence rates to desired levels.

Interest Rates in Fiji



Currently, interest rates in Fiji are at record lows. This is considered appropriate as there are no immediate threats to inflation and there is a need to continue to stimulate economic activity.

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