Note

Is there a case for a freely floating exchange rate in Fiji?

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In an article on 'Exchange rate and financial management: some lessons for and from Fiji', Chand (1998b) recommended the removal of discretion in the determination of Fiji's exchange rate and suggested its float as a policy option. He advanced two grounds

- the Reserve Bank of Fiji's current conduct of monetary policy—targeting the interest rate in the context of an apparently growing liberalisation of the capital account—would warrant the introduction of a clean float rather than the current managed float
- the benefits arising out of a freely flexible exchange rate would be substantial as it would serve as a daily barometer on the soundness of macroeconomic management and discourage speculative activities. Chand also pointed to the negative effects of frequent devaluations, besides speculative activity, such as disincentives to hold domestic currency and uncertainty of profits from investment.

This note seeks to analyse and evaluate the current domestic and international situations and examine whether there is any case for a clean float in Fiji.

Monetary policy

In mid-1997, the Reserve Bank of Fiji changed its approach to conducting monetary policy by targeting the interest rate rather than the monetary aggregate, M2 (Reserve Bank of Fiji 1997). The reason behind the change was growing concern about the unpredictability of demand for money. An interest target (yield on Reserve Bank of Fiji's 91-day notes) was adopted. There have been no indications as to whether Fiji has any plan to rely on capital inflows for bridging current account deficits in its balance of payments and whether targeting the interest rate was part of any design for using monetary policy to attract overseas private sector funds into Fiji dollars. In fact, the indications have been to the contrary: the exchange controls on capital account transactions are still in place. There has been some relaxation of controls from time to time, announced as part of annual budgetary measures for encouraging foreign direct investment, relating to the payment of dividends and repatriation of capital.

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Capital flows into Fiji

A review of two decades of foreign capital flows into Fiji shows that they have not been substantial. While capital inflows in recent years averaged 9 per cent of GDP, annual capital outflows over the longer term have averaged about 2 per cent of GDP (Morling and Singh 1998). Annual direct investment flows have been gradually rising, averaging from 2.5 per cent of GDP in the 1980s to 3.3 per cent of GDP during the 1990s (Table 1). The Reserve Bank of Fiji's short-term capital liabilities in foreign currency have been nil. Foreign currency loans have remained small and the proportion of foreign currency denominated liabilities of the banking system is also small.

The low level of capital flows into Fiji in terms of foreign direct investment can be explained by referring to more solid reasons than the mere small size of the economy. There is also a lack of appropriate complementary policies to improve the political climate and promote investor confidence by enforcement of contracts and property rights. There is no denying the fact that exchange controls reduce the value of all assets held in a country and overseas investors would be less willing to invest in a country where risks associated with repatriating profits and realised assets make investment less attractive. However, Fiji's cautious approach in terms of gradual removal rather than one-step dismantling of exchange controls has to be seen in the light of its preference for a sequential approach to reform processes rather than a one-off introduction of economy-wide reforms. Although there is no official pronouncement spelling out the strategy in regard to exchange controls, recent experiences indicate that liberalisation of exchange controls is being undertaken in a gradual manner.

Fiji's exchange rate pegged to a basket of five currencies (United States, Australia, New Zealand, the United Kingdom and Japan since 1975), allowing for certain flexibility within a band of transparent width from +/-0.07 per cent, together with exchange controls, has permitted monetary policy to play a supportive role. There have

Table 1 **Fiji: capital flows, 1980–97** (annual averages)

	1980–89	1990–97
Capital inflows (US$ million)	66.7	157.1
(per cent of GDP)	5.4	8.9
Capital outflows (US$ million)	30.3	39.7
(per cent of GDP)	2.5	2.1
Direct investment flows (US$ million)	25.1	62.7
(per cent of GDP)	2.5	3.3
Direct investment outflows (US$ million)	7.5	9.7
(per cent of GDP)	0.7	0.5

Source: International Monetary Fund, 1998a. *International Financial Statistics Yearbook 1998*, International Monetary Fund, Washington, DC.

Note

Table 2 **Fiji: variability in nominal and real effective exchange rate indices, 1980–97**

	Nominal effective exchange rate index		Real effective exchange rate index	
	Standard deviation	Coefficient of variation	Standard deviation	Coefficient of variation
1980–82	3.9	0.03	1.96	0.01
1983–85	4.16	0.03	1.55	0.01
1986–88	15.07	0.13	15.33	0.13
1989–91	0.66	0.01	1.44	0.01
1992–94	1.27	0.01	1.83	0.02
1994–97	1.98	0.02	3.05	0.03

Source: International Monetary Fund, 1998a. *International Financial Statistics Yearbook 1998,* International Monetary Fund, Washington DC; Author's calculations.

been two devaluations of the currency in 1987, amounting to a cumulative 33 per cent, and another in 1998 by 20 per cent. These two measures confirmed the monetary authority's commitment to intervene, whenever considered necessary for maintaining export competitiveness, by bridging the gap between the real and nominal exchange rates (Jayaraman 1997). Table 2 illustrates the variability in nominal and real exchange rate indices.

With perfect capital mobility, the standard textbook (Samuelson and Nordhaus 1998: 610) observation would have been valid: the fixed exchange rate system with perfect capital mobility would not have permitted any freedom for Fiji to pursue an independent interest rate policy as it has to be closely linked with the interest rate of its trading partners. Fiji's exchange rate regime has thus served well as an anchor for inflation, especially in the context of the recent shift in the framework for the conduct of its monetary policy. The rate of inflation has been low, ranging from 1.2 per cent in 1994 to 2.9 per cent in 1997, and the foreign exchange reserves position has been reasonably comfortable as of December 1998 totaling F$761 million, equivalent to 4.5 months of imports of goods and non-factor services (Reserve Bank of Fiji 1999).

The monetary policy followed under the adjustable system, together with the exchange control procedures, was also found to be effective following the Asian crisis of 1997. Although there were strong pressures to fall in line with the Asian monetary authorities' actions to raise interest rates to stem the capital outflows, the Reserve Bank of Fiji resisted the pressures and continued with its low interest rate policy. The inflationary potential of the devaluation has largely been reduced by the deflationary conditions in the rest of the world—which eventually vindicated the Reserve Bank of Fiji's decision to persist with its low interest rate policy. The IMF's Public Information Notice in September 1998, following its Article IV Consultation with the Fiji authorities, announced that the Fiji's exchange rate regime had provided a stable macro-economic environment and monetary

policy had been effective in reining in inflation (International Monetary Fund 1998b).

If the exchange rate had not been pegged, an alternate mechanism would have been required. In addition to the Reserve Bank of Fiji's liquidity management measures, which were introduced in 1989 by way of open market operations in Reserve Bank of Fiji notes, fiscal policy since 1990 has been conservative. There has been some criticism that tight fiscal policies have resulted in curtailment of essential expenditures such as maintenance of the existing public assets as well as much-needed investments in physical infrastructures. The net result has been a low rate of inflation (Fallon and King 1995).

Four options

In their study on exchange rate policy in Papua New Guinea, Duncan et al. (1998) list four options for developing economies' exchange rate management

- a pure floating rate, under which there would be no official intervention and the nominal exchange rate would be market-determined
- a real exchange rate targeting, under which nominal exchange rate and monetary policy would be adjusted so that the real exchange rate is maintained at a predetermined level
- a nominal exchange rate anchor, under which the nominal exchange rate is maintained at a particular level with respect to a basket of foreign currencies
- a currency board, under which the monetary authority holds foreign reserves of a particular foreign currency, equal to at least 100 per cent of the domestic currency issued, and its nominal exchange rate is pegged to that foreign currency.

Duncan et al. (1998) observe that while currency board and pure float exchange rate regimes would require no official intervention, nominal and real exchange rate anchors would require frequent interventions; however, volatility in exchange rate would be the highest under a pure float, whereas under a currency board there would be no volatility at all, and under both nominal and real anchors there would be some degree of volatility. Regarding uncertainty, a pure float emerges to be free from any uncertainty whatsoever. On the other hand, there would be some degree of uncertainty under the nominal and real anchor regimes, depending on whether intervention is timely or otherwise, and in the interim period there could be speculative attacks.

While the pure float choice provides full freedom for independent monetary policy actions, the currency board option denies any freedom to pursue an independent monetary policy as the authorities have to tie monetary policy to that of the country against which its currency is pegged. Further, it cannot resort to any exchange rate adjustment by way of response to any external shocks, including adverse movements in terms of trade. The disadvantages of real rate targeting and the nominal rate anchor are that they are open to speculative attacks, for example where the former option misses targeting the appropriate real rate and where the latter is accompanied by incorrect macroeconomic policies, including a lax fiscal policy.

However, Duncan et al. (1998) make it clear that none of the four exchange rate regimes is superior to the others under all circumstances and that the choice is dictated by domestic priorities and dependent on international conditions. Specifically, with reference to Papua New Guinea, they observe that having successfully adopted prudent fiscal policies and acquired sufficient downward flexibility in wages and prices, the existing practice of excluding certain foreign exchange

transactions should be discontinued with a view to further deepen the foreign exchange market. This would enable the market to emerge from its present thinness and make the market for domestic currency more liquid.

Referring to international conditions, Duncan et al. (1988) observe that the past reasons for a nominal anchor no longer exist since the international rate of inflation is low and hence there is no fear of imported inflation and that substantial kina depreciation in the past has not set in train an inflationary process. Since the nominal rate anchor and real rate targeting options are fraught with the danger of speculative attacks, and as official interventions may not be timely and appropriately targeted, the pure float is recommended. They rule out a currency board option as being too restrictive as the country cannot have independent monetary and fiscal policies; and since Papua New Guinea has displayed maturity in implementing appropriate macroeconomic policies, they recommend the adoption of a pure float which offers the fullest freedom for independent monetary policy. However, they have identified two preconditions

- Papua New Guinea's foreign exchange market should be further deepened by bringing in all transactions within the domestic market
- the remaining exchange controls should be discontinued, since it is undesirable to have them when the exchange rate is floated.

Literature on exchange rate regime

Before examining whether conditions in Fiji can be considered favourable for adopting the pure float option, it would be worthwhile to undertake a brief review of the literature. The early literature on the subject of exchange rates, which was based on the theory of optimal currency areas focused on the characteristics of an economy. Corden (1993) concluded after a review of operations of various exchange rate regimes of 18 developing countries in the 1970s and 1980s, that for small, highly trade-dependent open economies with less diversified production and export structures, a completely fixed exchange rate was desirable and a currency board would be even more appropriate. Later experiences showed that the currency board option is better suited to those countries which in the past had an extremely poor credibility record in fighting inflation, since the option imposes highly restrictive conditions (Mishkin 1998).

Further advances in theory showed that the fixed exchange rate regime is superior if the disturbances impacting the economy are predominantly of a domestic nominal nature, such as interest changes, whereas the flexible system is preferable if the disturbances are of external origin such as terms of trade or domestic real shocks such as natural disasters (International Monetary Fund 1997).

Conditions in Fiji

Fiji's inflation control record is credible and there have been no instances of run-away inflation. Further, fiscal policy in the recent past has been conservative as budget deficits have been sustainable. Recent aberrations in fiscal deficits have been due to one-off expenditures to rehabilitate the poorly performing National Bank of Fiji. Aside from this, there have been no deliberate expansionary fiscal stances. In these circumstances, one can rule out the currency board option.

Two episodes of capital instability have occurred during the last two decades: one in 1987, which was associated with business sentiment following the two military coups rather than any deviations from the fundamentals, and in late 1994. In

the first case, there was a firm intervention by way of two devaluations, stemming the capital outflows. In the second case, when there was some speculation prior to the budget presentation to the parliament, temporary policy measures including rises in Reserve Bank of Fiji overnight lending and repurchase rates, closure of the rediscount window and suspension of the forward cover facility for the commercial banks were resorted to. These measures proved effective against the capital outflows (Morling and Singh 1998). The January 1998 devaluation was more of a preemptive kind to deal with a potential threat following the East Asian currency crisis. Barring these episodes of capital instability over an 11-year period, the Fiji dollar has not at any time been under any imminent threat of the kind similar to that witnessed recently in East Asia, requiring the currency to be floated.

Fiji's exchange rate in the past has been relatively stable in the short run, assuring traders to enter into transactions without the uncertainty of sharp and unpredictable changes in relative prices. With half of domestic spending and domestic output being trade related, volatility associated with a pure float would adversely affect the efficiency of trade transactions. The absence of financial mechanisms in Fiji to insure against exchange rate risk, as was the case in Papua New Guinea, would compound the problem. Due to the openness of the economy, Fiji is particularly vulnerable to induced shifts in prices. Although changes in exchange rates have one-off price effects, slow adjustment of prices to their new equilibrium levels and the likelihood of second round effects on wages can result in more entrenched rises in inflation and inflationary expectations. The goal of price stability would then be unattainable.

Fiji's low inflation has been due to the pegged exchange rate regime as the five countries (Australia, New Zealand and the United Kingdom, all three having explicit low inflation targets and United States and Japan, both committed to maintaining low inflation) whose currencies figure in the basket, have been enjoying relative price stability. This has contributed to keeping inflationary expectations in Fiji low. From the monetary policy point of view this is important as Fiji's macroeconomic credibility has not been firmly established. In the absence of a stable and predictable relationship between inflation and other intermediate targets, including monetary aggregates and credit, the exchange rate has served well as a nominal anchor.

Since the financial markets are not deep and liquid, a slow and gradual sequencing of reforms in the financial and real sector are needed before liberalising the capital account —the major requirement for launching a pure float in Fiji. Furthermore, when there are swings in foreign exchange earnings largely associated with seasonal patterns in sugar exports and tourism, the exchange rate under a pure float would be seriously affected. As Fiji's financial market infrastructure is underdeveloped with only a few major players in the primary market and with no secondary market for government and private sector debt instruments, the pegged exchange rate system would thus appear to be more appropriate. The financial sector is small and relatively small movements of capital would have severe impacts on the exchange rate under the pure float option. Frequent, sudden and unpredictable changes would have imposed severe costs on the economy, adversely affecting foreign trade and business activities.

It is also feared that since some critically important national issues are still to be resolved, such as restoring investor confidence and the promotion of political stability under the new government in mid-1999, a pure float would not be advisable at this stage; and the shifts in exchange rates in the event of a pure float are likely to be more, and of substantial magnitude, as a

result of political uncertainty. Shifts of this nature are different from those which are in line with the fundamentals and hence undesirable.

A continuum

While considering the options for Fiji, one should not view the choice between a fixed exchange rate and a floating exchange rate as dichotomous. In fact, observing that the degree of exchange rate flexibility lies on a continuum, with crawling pegs and managed floats of various other kinds residing between the extremes of floating and irrevocably fixed, Obstfeld (1998) makes it clear that the notion of a free float is an abstraction, with little empirical content as few governments are willing to set monetary policy without some consideration of its exchange rate effects. The greater the attention given to the exchange rate, the more constrained monetary policy is in pursuing other objectives.

Fischer (1997) of the International Monetary Fund has gone on record to say that there was no agreed answer to the question of the optimal approach under normal conditions. The solution appears to be that it would be far better for a country to peg to a basket of currencies and adopt some form of exchange rate band with very wide margins, perhaps a crawling band; its authorities should also stand ready to move the band as circumstances warrant, together with a willingness to adjust the country's macroeconomic policy when the exchange rate (equivalently, balance of payments) shows signs of moving out of desired ranges (Fischer 1997:322).

A recent study by Ohno (1999) has underlined the need for pragmatism in exchange rate management. Specifically referring to choosing among the systems, Ohno cautions that the choice of the exchange rate system does not matter too much as long as the two extremes of permanent rigidity and free float are ruled out. The crucial question is management, rather than the system chosen. To this extent, there is no theoretical justification but such an approach can be justified on practical grounds.

Priority areas of attention

The Pacific island economies, including Fiji, are akin to those of the African economies, whose goal is to attract and retain capital. This is slightly different from the Asian situation. Having attracted enormous capital inflows and enjoyed long periods of prosperity, the East Asian countries are now struggling to retain it. Fiji's priorities include improving the governance image of the country and raising investor confidence, both domestically and internationally.

Specifically, the four priority areas of attention which have been identified by a recent study by Fischer, Hernandez and Khan (1998) on Africa are relevant here

- high transactions costs in regard to property rights and contract enforcement, hampering the countries' comparative advantage in certain investment activities
- inadequate physical infrastructure and stock of human capital, resulting in the shift of resources away under globalisation process to those better-placed countries
- barriers to foreign trade, preventing the gains from improved resource allocation
- corruption and waste in the public sector, tilting investments toward large and wasteful projects and in the process further increasing transaction costs.

These four priority areas should now receive focused attention in Fiji. Certainly, the freely floating exchange rate system is not the need of the hour and it can be considered at a more opportune moment.

Note

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