As Fiji's foreign exchange reserve level has declined since January 2008, the money supply has also decreased — TK JAYARAMAN

Can we do a 'Ben' in Fiji?

Tourists buy handicraft items along Stinson Parade in Suva yesterday. Picture: ELIKI NUKUTABU

Economics Associate Professor TK JAYARAMAN explores why right now is the time for Fiji to cut costs and save rather than implement massive fiscal stimulus packages such as those being implemented in the US

T K Jayaraman

MY column on US central bank chairman Ben Bernanke's action to move the economy by increasing money supply, provoked many readers to ask me "can Fiji do the same"?

Another related question is whether Fiji can resort to fiscal stimulus initiatives similar to those undertaken elsewhere.

The answer to both questions is no.

Presently, Fiji cannot afford to take any of the measures.

Both measures have serious balance of payments implications for Fiji, with likely fears of fall in the value of the Fiji dollar. Fiji's fixed exchange rate regime has given a high degree of stability to the value of the currency. One of the gains is low inflation.

Effects of expansionary policies will be felt primarily in the deterioration of external accounts in its balance of payments, exercising pressures on the Fiji dollar.

Fiji's trade forms a very high proportion of its gross domestic product (GDP), with a high degree of import dependency for food items, manufactured and capital goods and petroleum products.

Growing current account deficit

Fiji's export earning in past years has been less than expenditure imports. Tourism and remittance have been a great support. However, the net position known as current account in the balance of payments is worsening. Current account deficit was 7 per cent of GDP in 2000. It rose to 16 per cent in 2007 and 21 per cent in 2008.

Tourism earning and remittance are seasonal in any given year. In market place, Fiji dollar would be decided by interaction of supply and demand forces. Under flexible rate regime, volatility introduced by uncertain export earnings when imports are rising would result in frequent depreciation of Fiji dollar. Any fall in value of Fiji dollar would make imports more expensive and inflation would be the result. Past studies have shown that Fiji's inflation is mostly imported.

Of course, depreciation of currency would make Fiji's exports cheaper and attractive to foreigners. Since supply response of exports to price changes is always slow, net gains from depreciation of currency would be negative for a small economy with a limited range of exports.

Depreciation of the currency cannot be a remedy to correct trade imbalances.

Fiji can make its exports cheaper only through higher productivity gains. Currency depreciation is not the route.

Having adopted the fixed exchange rate regime, monetary policy objectives of Fiji are maintaining a stable exchange rate and price stability.

Toward the first objective, Fiji defends the exchange rate by maintaining an adequate level of reserves, in terms of months of imports. When things are not bright on the horizon, it has to put breaks on consumer and investment spending so that the demand for imports is kept under control. The country with a fixed exchange rate regime has to abide by high standards of fiscal and monetary discipline.

Expansionary monetary policy with money demand unchanged, typically leads to both increases in imports of goods and services and capital outflows. This leads to fall in net foreign assets of the central bank, signifying a decline in reserves.

If capital flows were fully mobile, private sector can take advantage of interest rate differential, and shift their cash holdings overseas. Net domestic assets would then rise, which is quickly offset by a decline in net foreign assets, leaving money supply unchanged, a situation in which monetary policy will be ineffective.

With exchange controls in place, Fiji has some measure of monetary independence.

Countries such as the USA have one automatic adjustment channel, which is exchange rate itself. If domestic money supply increases, the value of the currency goes down automatically, reflecting the excess supply of money over its demand. Exchange market reacts, anticipating a rise in domestic price level following money supply increase. It happened last week when the US Fed injected $US1.15trillion. The American dollar plunged, giving a boost to its exports.

In the absence of substantial reserves, expansionary policies would only put pressure on exchange rate. The consequences will be disastrous for the economy.

The remedy

Fiji's official international reserves at the end of February 2009 were about $F672million (equivalent to 2.7 months of imports) as against $F938.2million (3.5 months of imports) one year earlier.

Borrowing from overseas by floating a bond is an option, With today's unfavourable conditions, Fiji cannot entertain such an idea.

The International Monetary Fund (IMF) announced a new scheme under which middle income countries, including Fiji can borrow to weather the present crisis and return to sustainable growth. The new loan scheme is reported to have flexible credit terms, with streamlined loan conditions and simplified costs, toward enabling greater access to resources. Further, the borrowing countries will not be subject to the controversial conditions that are normally attached to IMF loans. Fiji can explore this avenue.

"Banks can also rise to the occasion by helping the economy to save more through vigorous mobilisation of bank deposits. One way is to offer higher rates of interest on deposits. With low foreign exchange reserve level, it would be far better to encourage savings in all directions."

Liquidity in the system

As Fiji's foreign exchange reserve level has declined since January 2008, the money supply has also decreased. The reason is money supply under a fixed exchange rate regime is the sum of net foreign assets and domestic credit. For quite some time now, the Reserve Bank of Fiji (RBF) has suspended its open market operations, which were used for absorbing excess money. Therefore, the primary reason behind the fall in money supply is the fall in international reserves.

However, liquidity in the banking system can be increased. It is left to commercial banks to add to their reserves for more credit creation. Two ways are open — overnight inter-bank borrowing and borrowing from RBF, which acts as the lender of last resort.

The RBF has halved its minimum lending rate for loans to commercial banks from 6 per cent to 3 per cent. Additionally, RBF has an export finance facility under which commercial banks can borrow at a maximum interest rate of 2 per cent and lend to exporters at a concessional rate.

Of course, RBF can reduce the current statutory reserve deposit (SRD) ratio of 6 per cent so that more reserves can be made available to banks for increased lending and creating deposits.

Thrift as a virtue

Banks can also rise to the occasion by helping the economy to save more through vigorous mobilisation of bank deposits. One way is to offer higher rates of interest on deposits.

With low foreign exchange reserve level, it would be far better to encourage savings in all directions. Government ministries are at present reviewing their budget for effecting savings. Cost-cutting exercises would enable finding additional resources for capital expenditures, without sacrificing budgeted capital expenditure.

The present worldwide financial crisis, caused by greed and a huge appetite for cheap loan money, has reminded the world of an old virtue — thrift.

Long time ago, Confucius said: "He who does not economise, will have to agonise".

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