FIJI TIMES

Saturday, March 26, 2011

Consider flexible rate

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Three events in March have re-kindled public interest in the long pending policy reforms facing the Fiji's economy.

First, on March 9, there was a launch of the February issue of ***Pacific Economic Monitor*** (PEM). This tri-annual publication by Asian Development Bank is devoted to a review of latest economic trends in the Pacific island countries including Fiji, with a set of policy reforms for consideration by decision makers in the region.

The second one, which hit the newspaper headlines on March 10 was Fiji's successful issue of its second international bond for US$ 250 million (F$500 million). It re-confirmed the credibility of Fiji as a creditworthy nation. The bond issue would enable to pay out the obligations of the previous bond issue of 2006 for US$150 million (F$300 million). Furthermore, it would also add to Fiji's international reserves.

Avoidance of conditionalities

More importantly, the bond issue has helped Fiji avoid the conditionalities, which are attached to credit facility, known as Standby Arrangement (SBA) from International Monetary Fund (IMF) to bail out a member country from its balance of payment difficulties. These conditionalities enforce implementation of reforms including restoring budget balance and closure of non-profitable public enterprises and other fiscal tightening measures over a stipulated period during which the loan amount would be disbursed in steps, known as tranches.

The troubled countries in the Euro zone are now undergoing these painful adjustment measures or what the placard carried by the street protestors in Dublin described: Imposed Misery Forever (IMF).

In June 2010, Fiji was exploring the possibilities of seeking assistance from IMF of no less than F$1 billion. Now with the second bond issue, Fiji has avoided the conditionalities. It does not mean the need for reforms has vanished or lost urgency.

In fact, it is the opposite. The bond issue has brought policy issues to the fore for consideration. A panel discussion by Fiji's economists and high ranking officials from the government is scheduled next week.

IMF Article IV Mission findings

The third significant occurrence was on March 14. That was the Public Information Notice (PIN) on the Report of the IMF Mission to Fiji in late October-November 2010. The PIN, which is intended to promote transparency of IMF's activities, is issued with the government consent, after IMF Executive Board's discussion of reports of IMF Missions to member countries.
The PIN on IMF's Mission Report highlights areas of reforms: budget balance, revamping sugar industry, and reducing public debt from the current level of 59% of gross domestic product to a more sustainable level.

Flexible exchange rate

One important reform that was put forward needs attention. The IMF has recommended that Fiji should adopt a more flexible exchange rate regime to help absorb shocks and protect reserves. According to IMF, the appropriate first step would be to move to an exchange rate band of ± 2 percent to 3 percent around the current rate.

The recommendation is apparently based upon IMF's evaluation of the size, timing and impact of the April 15, 2009 devaluation of Fiji dollar on the economy. The devaluation was by 20%; from 57 cents US on April 14, 2009 to 45 cents US on April 15 2009.

Economists refer to the measure as expenditure switching effort, as devaluation makes imports more expensive and consumers would reduce consumption of imports and switch to local products. Foreigners would find exports of the devaluing country cheaper and so exports would rise. The balance of trade would then dramatically improve.

That did not happen. The reasons are Fiji is heavily dependent on imports from food and fuel to manufactured goods; and its range of exports is narrow and small. Foreigners' dependence on Fiji's exports is not as high as Fiji's dependence on imports. In economics, the relevant term is price elasticity of demand. The well known Marshall-Lerner theorem states that devaluation would improve balance of payments only if the sum of the price elasticities of domestic demand for imports plus foreign demand for exports exceeds unity. Obviously, this critical condition is not satisfied. On the other hand domestic price level went up as Fiji's demand for imports is highly price inelastic. The result is a high degree of exchange rate pass through.

The April 2009 devaluation was however justified on the ground that it was long overdue. There was a deviation from the fundamentals for long and it needed correction. Pressures on exchange rate, owing to low international reserves level, fuelled rumours; and there were capital outflows.

That raises the question whether Fiji should have acted much earlier or whether Fiji should have adopted a flexible exchange rate regime as prevalent in Australia and New Zealand.

The debate on desirability of a flexible exchange rate regime for small, open island economies is not new. After much debate on pros and cons, it was agreed that small and open economies which are heavily dependent on imports and whose foreign exchange earnings, mostly from tourism and agricultural exports, are only seasonal and not steady throughout the year, should adopt a fixed exchange rate. Further, if the monetary authority aims at price stability, as one of the major objectives besides growth, fixed exchange rate regime is advisable.

The IMF has acknowledged the role of fixed exchange rate in Fiji as the anchor for monetary policy. However, the question is how long a country can stick to a rigidly fixed exchange rate when fundamentals were rapidly deteriorating.

Would not the fixed exchange rate regime policy with some built- in flexibility be helpful to absorb external shocks such as changes in terms of trade? The recommendation is an exchange rate band of ±2 percent to 3 percent around the current rate. That kind of flexibility would be more helpful and less painful than a one-shot, steep adjustment of the kind Fiji had to undergo in April 2009.

Already, Fiji's neighbours have similar adjustment bands: Samoa (±2 percent) and Tonga (±5 percent).

The recommendation is worth considering.

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