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Deepening global currency crisis

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The emerging markets' currency crisis is deepening. The war clouds in West Asia add to worries. The price of oil quoted in US$ is rising.

Economic news: more of the same

Advanced economies are battling with slow growth, while developing countries with floating exchange rates are struggling with their falling currencies.

The currency crisis since May was triggered by US Federal Reserve Chairman Bernanke's remark that he would taper the monthly bond purchases by end of the year. The bond purchases have helped reduce the benchmark interest rate to zero for encouraging investment and growth.

Bernanke's remark rattled currency markets in Brazil, Russia, India, Indonesia, South Africa (BRIICS) and Turkey. Investors, who flocked to BRIICS because of their higher interest rates since late 2008, are now pulling out their funds and turning to the US.

Currencies of India and others saw bigger declines since May. On Wednesday, August 28, Indian rupee fell to record low: 68.75 rupees against the US dollar, though recovering later to 66.70 rupees.

While Reserve Bank of India hesitated to intervene and sell dollars out of its reserves of about US$ 279 billion to stabilize the currency, Brazil decided to sell US$60 billion to stop depreciation of its currency, the *real;* and Indonesia also announced it would do so. Peru's central bank already sold US$600 million to save its currency *Nuevo Sol.*

Currency interventions are not unusual.

In September 1992, the British sterling was under siege. The Bank of England (BOE) tried to defend sterling by selling German mark and finally gave it up. The much dreaded devaluation of sterling finally materialized.

A country's capacity to defend its currency by selling foreign exchange is limited. The limit is imposed by availability of reserves.

That is the problem every country would have to face when a currency crisis develops.

"It is our currency; and it is your problem"

Thirty five central bank leaders from developing economies, who attended last week the annual meeting in Jackson Hole, Wyoming in America organized by the Kansas City Fed, expected some assurance from the Fed on timing and some kind of slowdown in the tapering of QE.

China has a fixed exchange rate regime and is fortunately spared of volatility in currency markets. One Chinese banker voiced his concern:

"Given that the US monetary policy has a huge influence on emerging markets we hope that the US monetary policy authorities, whether exiting or scaling down stimulus, will not only consider the US's own economic needs but also think about economic situation in emerging markets."

However, to their dismay, their plea was of no avail.

In the absence of chairman Bernanke, other Fed officials responded.

According to the Bloomberg news, president of the Atlanta Fed said: "You have to remember that we are a legal creature of Congress and that we only have a mandate to concern ourselves with the interest of the US. Other countries simply have to take that as a reality and adjust to us if that's something important for their economies."

The St. Louis Fed president was blunt. He said their concern was domestic economy and they were not going "to make policy based on emerging-market volatility alone".

It now looks certain that the Fed would taper QE purchases by year end.

Implications for Fiji

Fixed exchange rate regime has some advantages. The exchange rate is not at the mercy of daily changes in supply and demand forces. Fixed exchange rate minimizes volatility. If a country has sufficient reserves, it can withstand pressures on exchange rate in the midst of external shocks of the kind beyond country's control, such as war in the Middle East or food prices overseas.

Fiji's foreign reserves are about F$1.8 billion, sufficient to cover 5.1 months of imports of goods and non-factor services. No surprise, Fiji's high level of foreign reserves has prompted the recent IMF Mission to suggest a flexible exchange rate regime.

The suggestion is not new as it has been made several times during last one decade.

Fiji depends on a narrow range of exports of goods, such as sugar and vegetables and services such as tourism. As these are affected by seasonal factors, foreign exchange earnings are not steady throughout the year. Unforeseen natural disasters further compound the problem.

On the other hand, imports of staples such as rice and wheat and other consumer goods are steady. Violent variations in earnings with no such variations in import expenditures would contribute to volatility in exchange rate, if it is allowed to float.

Volatility in currency affects future investment decisions, besides disturbing price stability.

Fiji critically depends on capital and intermediate goods for any manufacturing activity. A steady and credible exchange rate policy is important for all future transactions, including imports and investment decisions.

The fixed exchange rate regime has served the country well.