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Safe level for foreign reserves

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Uncertainties arising from the Ukraine and Middle East conflicts with their likely upward impact on commodity prices are causing worries to policy makers. Ukraine is one of the world's largest wheat exporting countries; and the Middle East is the area on which the world depends for oil supply.

What is the safe level for foreign reserves to meet any eventualities?

The indicator of sufficiency level is import cover. That is, the number of months of imports a country's existing reserves could cover.

Fiji's foreign reserves just days before the devaluation in April 2009 were at the lowest ever: F$360 million, an import cover of five weeks.

Today, the level of official foreign reserves of Reserve Bank of Fiji is at a more comfortable level: F$ 1,661 million with import cover of 4.4 months.

World's largest holder

American dollar is the world's major reserve currency. The rest of the world has to earn dollars by exporting goods and services.

China's reserves are US$6.0 trillion, which is more than 50 percent of country's GDP. Its central bank holding is US$ 4.0 trillion, providing an import cover of two years. It exceeds the combined reserves of the other four members of BRICS group: Brazil, Russia, India and South Africa.

China, the largest holder of US dollars, is still building up the reserves.

The latest burger index analysis based on purchasing power parity by the *Economist* of London shows that if the Big Mac price in America is US$4.80, at the current exchange rate it costs only US$2.73 in China. Thus, the renminbi undervalued by 43 percent makes China's exports cheaper. Under a fixed exchange rate regime, it effectively intervenes in the market by buying dollars and selling renminbi, now and then for keeping the currency low.

Is there any safe cover?

While import covers for Brazil and Russia are much higher at 18 and 17 months, India's reserves are US$320.6 billion, providing an import cover of 8 months. This is much less than the level of reserves India had in 2008, when the import cover was 15 months. India's imports are recently increasing faster. The *Economist* of London says a three months import cover is enough for India.

That brings us to the topic: import cover for PICs including Fiji.

Factors affecting reserves

PICs with the exception of PNG have a narrow range of exports and they are highly dependent on imports, ranging from food and fuel to manufactured consumer goods. That creates a constant worry about the adequacy of reserves.

Rising imports and decreasing exports create trade deficits. Undoubtedly, rising imports reflect economic growth and development, requiring imports of capital goods including machinery. Decreases in export earnings are due to falling overseas demand for exports and adverse terms of trade: higher import prices compared to export prices.

Trade deficit as percent of GDP for Fiji last year is much higher (at 22.6) compared to: Samoa (44.1); Tonga (30.1), and Vanuatu (34.1) and Solomon Islands (4.7).

As PICs are well supported by tourism, remittances and official aid, current account deficits as percentages of GDP are sustainable for Samoa (13.4); Solomon Islands (5.5); Tonga (6.8) and Vanuatu (6.2). Fiji's current account deficit is the highest of all, at 22.5 percent.

Current account deficits are not worrisome, if they are financed by non-debt creating inflows such as foreign direct investment (FDI).

If FDI inflows are not high enough and if government wants to avoid external borrowing, reserves have to be run down. While Solomon Islands has the highest import cover at 11.3 months, Tonga (9.4) , Vanuatu(6.9) and Samoa, Fiji's import cover is the least at: 4.4.

Part of the reason is steep rise in capital expenditure in the first six months of this year, "something which wasn't experienced in previous years", says Mr. Waqabaca, Permanent Secretary (PS), Ministry of Finance. The government departments were asked to reach their 90 per cent implementation of their projects by June.

That explains the falling trend in reserves and import cover during last 6 months: excess aggregate demand always spills over into foreign sector resulting in higher imports, decreasing the reserves level.

In January 2014, reserves were: 1,763 million (4.7 months): February 1,696 million (4.5 months); April: 1,667 million (4.5 months); June: 1,679 million (4.5 months) and July: 1,661 million (4.4months).

Experience indicates that 4.4 months import cover seems presently sufficient. In 2010, reserves were F$1.3billion (4.4 months); in 2011 F$1.5billion (4.9 months); in 2012 F$1.6billion (5.1 months); and in 2013 F$ 1.8billion (4.6 months).

With four more months to go, expected tourism earnings and remittance inflows would further augment reserves.