ECONOMIC ISSUES FOR CLASSROOM DISCUSSION

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Foreword

I am pleased to write this Foreword for this volume of selected newspaper articles by Professor Jayaraman, Department of Economics, School of Economics, Banking and Finance, College of Business, Hospitality and Tourism Studies, Fiji National University.

Professor Jayaraman has been writing for the local newspapers ever since he took up teaching in Fiji after his retirement from the Asian Development Bank in 1997, besides his academic contributions in learned journals. His work on a single currency for the Pacific island countries is well known.

The articles in this volume, which were selected from his more than 300 newspaper articles over a period of 10 years, cover some of the most important events in the business and finance world, both in developing countries including Fiji and other Pacific island counties, and the developed countries. Aside from highlighting the significant events, Dr Jayaraman analyses their implications and likely impact on small island countries in the Pacific.

His regular weekly column has become popular amongst all, laymen and professionals. Written in simple language and free from jargon, the articles are well balanced analyses without any bias. That is the hallmark of Dr Jayaraman, in the best traditions of how John Maynard Keynes wanted economists to be, “professional and humble as dentists”. I refer to the last article in this collected volume, “Of economists, dentists”.

I am aware that these articles are increasingly used by teachers as tutorial material in high schools. In response to the demand for making the articles available in a single volume, Professor Jayaraman has put these articles together.

I commend the publication to all teaching institutions in Fiji and other Pacific island countries.

Prof. Ian Rouse
A/Vice Chancellor
In addition to teaching and research activities undertaken during my teaching career which began in 1998, I have been writing for the newspapers in Fiji for more than a decade. The present volume contains 50 selected articles, which appeared in The Fiji Times and The Fiji Sun during the past 14 years.

Teachers in schools in Fiji have been using my articles for their tutorials.

I was recently approached by some teachers who were also my students in the University of the South Pacific, to publish the selected articles in a single volume which can be readily used by them as teaching material.

In response to their wishes, I sought permission from the editors and publishers of both newspapers, for reproducing the articles. They welcomed the idea and readily gave permission.

I am grateful to The Fiji Times and The Fiji Sun for their permission. I am also grateful to the Acting Vice Chancellor, Fiji National University, Prof. Ian Rouse, for the Foreword to this edited volume and for all support and encouragement in bringing out the volume as a Fiji National University publication.

T.K. Jayaraman
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Nobody would like to recall bad events, let alone make a ceremony out of any remembrance!

Yet, there are exceptions.

They are solemn anniversaries, though they are never looked forward to year after year. However, they serve the purpose: strengthening our resolve to take remedial steps for ensuring such events do not re-occur.

One example: the annual remembrance of the atomic bombing of the two Japanese cities of Hiroshima and Nagasaki, on August 6 and 9, in 1945.

**Perilous journey with a single step**

How about series of events, though of less intensity, the first of which took place on the seventh of August, five years ago? On that day, a French bank terminated withdrawals from three hedge funds citing “a complete evaporation of liquidity.” That was a dangerous development, as it indicated an impending deterioration in the balance sheet of banks.

A year later, Bear Stearns went bankrupt, followed by the collapse of Lehman Brothers on September 20, 2008.

A ten-member Financial Crisis Inquiry Commission (FCIC), appointed by the US President in 2010, observed:

“There are more than 26 million Americans who are out of work, cannot find full-time work, or have given up looking for work. About four million families have lost their homes to foreclosure and another four and a half million have slipped into the foreclosure process or are seriously behind on their mortgage payments. Nearly US$11 trillion in household wealth has vanished, with retirement accounts and life savings swept away. Businesses, large and small, have felt the sting of a deep recession”.

The contagion spread far and wide. It became a global financial crisis (GFC) in 2008 and then a world recession, which is now a bottomless pit.
A combination of factors

The GFC stemmed from a combination of factors. The first and foremost was increased savings from high growth emerging economies, whose investors entered capital markets in the developed countries. The “Giant Pool of Money” led to a rise in the global pool of fixed-income securities: from approximately $36 trillion in 2000 to $70 trillion by 2007.

Such an immense flow of savings into USA, the UK and Europe, was a challenge to regulators. Lenders and borrowers went mad with generating bubbles after bubbles. Reckless lending and risky financial adventures followed. Fancy financial products emerged and they were used by financial institutions as collaterals to borrow against.

Easy credit conditions prior to 2007 encouraged lending and risky borrowing practices; trade deficits; housing and real estate bubbles; budget deficits, and measures bailing out banks, all created a financial nuclear bomb. Excess supply of housing and commercial property led to a burst in the real estate market.

There was a domino effect. Asset prices began to decline. Liabilities owed by financial institutions to global investors did not go down in value, generating questions regarding the repaying ability of consumers, governments and banking systems. Thus, the solvency question not only of households and business houses, but also of financial institutions, emerged.

A disaster

It was a disaster of unprecedented proportions. Banks cut their lending as they were scrambling for liquidity. A credit crunch followed. Households, business houses and governments were no longer able to borrow and spend at pre-crisis levels. As demand declined, firms reduced investments and cut jobs.

Unemployment compounded the sufferings of households. They failed to meet their repayment obligations to financial institutions.
As documented by FCIC, five major investment banks in 2007—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were operating with inadequate capital. Their leverage ratios were as high as 40 to 1. For every $40 in assets, there was only $1 in capital to cover losses.

Major financial institutions collapsed, deepening the credit crunch.

In its final report submitted to the US President in January 2011, the FCIC did not spare the US Federal Reserve and policy makers.

The report concluded: “The crisis was caused by:

- widespread failures in financial regulation, including the Federal Reserve’s failure to stem the tide of toxic mortgages;
- dramatic breakdowns in corporate governance including too many financial firms acting recklessly and taking on too much risk;
- an explosive mix of excessive borrowing and risk by households and Wall Street that put the financial system on a collision course with crisis;
- key policy makers ill prepared for the crisis, lacking a full understanding of the financial system they oversaw; and systemic breaches in accountability and ethics at all levels.”

As we remember the first episode of the financial disaster, which happened this month five years ago, any excuse that it was inevitable and was to happen, would not be acceptable.

The FCIC observed:

“The greatest tragedy would be to accept the refrain that no one could have seen this coming and thus nothing could have been done. If we accept this notion, it will happen again.”

At the beginning of 2013, one question looked large: would the two crises, recession and the Euro problem, end soon?
2. Do Economic Crises Ever End?

The answer was ‘no’.

No war ended quickly. So with economic crises. World War II was fought from 1939-1945 and consisted of many battles, including the Battle of Britain, El Alamein, Arnhem, the Battle of the Bulge and so on. Similar to war, an economic crisis is never over until it ends. Each crisis has its own episodes: one followed by another.

The US recession crisis continued from one episode of the so-called fiscal cliff to another. The fiscal crisis is the debt ceiling of US$ 16.4 trillion, laid down by the US legislature. If America hit this ceiling by February, the salary payments to government servants would be stopped.

Following the inauguration of Democrat President Obama’s second term on Tuesday 21 January, the Republican party-dominated lower House of Congress decided the following day to suspend the ceiling law for three months, requiring a new budget blueprint by April 15. The Republicans, who failed in their attempt to derail President Obama’s re-election, are keen not to alienate the electorate any more. Within the next two months, the US Congress had to pass a budget and clear the way for negotiations on long-term deficit and debt reduction. The Republicans were expected to insist on spending cuts -dollar to dollar- on the debt ceiling. The IMF’s world report on growth prospects released on 23 January 2013 cautions that America should avoid “excessive fiscal consolidation in the short term, promptly raise the debt ceiling, and agree on a credible, medium-term fiscal consolidation plan, focused on entitlement and tax reform.”

Independent studies called for US$1.4 trillion in deficit reduction, approximately the same amount proposed by Obama. The Republicans were not satisfied. They wanted more. The next episode began.

The Euro crisis

The Euro crisis was temporarily patched up in December, when Greece, a member country of the 17-member Eurozone in the 27-member European
Union was assured another €50 billion with stringent conditionalities of more austerity, deregulation and reforms including closure of public enterprises or privatisation.

However, the other members are not yet free from their ailments: Ireland is in the sixth year of recession, Portugal on the edge of economic contraction and Spain with a deteriorating economy. The remedy again is austerity.

Since September, when the European Central Bank decided to buy the debt of the member countries in distress, the spreads on Italian and Spanish debt have fallen by 2.5 percentage points. The launch of the European Stability Mechanism with an additional €500 billion also contributed to the market calm.

**Simmering discontent**

There is, however, discontent based on the perception that Germany is not sharing its gains from its Eurozone membership.

Germany's inflation was lower than the Eurozone inflation target. Further, its worker’s discipline and wage restraint contributed to the competitiveness of its exports, not only to Eurozone, but to the rest of the world. Booming exports contributed to Germany’s trade surplus. Depreciation of the euro also helped Germany’s rising exports to the rest of the world. Why then could not Germany share the prosperity with the rest of the Eurozone?

If an independent country is in dire straits, it can devalue its currency to promote growth through exports. The members of the Eurozone cannot do it. If an independent country builds up export surplus, its currency appreciates. That did not happen in the case of Germany, being a member of the Eurozone with a single currency.

Germany is against fiscal union. It is against a banking union. Its tax payers are against using their moneys to help others.

In America, California is part of the dollar zone. It has no independent currency and has no exchange rate of its own. So, it is the fiscal transfers
from Washington D.C. which come to the rescue. Eurozone is not like America. It is not a political union.

The IMF’s forecast says the Eurozone will remain in recession. In the meanwhile, British Prime Minister David Cameron has contributed to the next episode of the euro crisis with a decision to hold a referendum on British membership of the European Union. Cameron says the EU was heading in a direction that British voters had never approved. He wants a referendum sooner rather than later, before it became more likely people would want to leave.
Two central banks in our region, the Bank of England (BOE) and European Central Bank (ECB) for the 17-nation Eurozone, have all decided to play safe: they would be maintaining their current monetary policy stances unchanged.

While on August 30, 2010, the Reserve Bank of Fiji (RBF) left its policy rate at 0.5% unchanged for the eleventh consecutive month, on September 4, the Reserve Bank of Australia (RBA) decided to maintain benchmark interest rate on hold at 3.5% for the third month in a row. On September 6, BOE kept interest rates at 0.5%, now for more than three years, and ECB its rate also at historic low 0.75% for the third month.

In August, it was expected the recovery of the world economy would be led by China despite uncertainties in Europe. The ECB President also assured the world that he would do whatever it takes to save the euro.

Dismal data

The latest economic data are dismal.

The euro crisis is prolonging with no action. In the Eurozone, output is falling. In 2012, it is now estimated it would shrink 0.3% and Germany would grow only by 0.7%. Moody’s has lowered the European Union’s AAA rating to negative. The British economy has just been forecasted to contract in 2012 by 0.7%. The Chinese economy is faltering. Its manufacturing fell to a nine-month low in August and growth will be less than 8%, the lowest in 13 years.

In America, this week attention was on divisive politics with the national conventions of the two parties. In his speech at the annual meeting of central bank governors in Jackson Hole, Wyoming, on August 30, the US Federal Reserve chairman admitted that the economy “is obviously far from satisfactory,” and the weak job market is a “grave concern” causing “enormous suffering and waste of human talent.”
The impact of the European slide into recession, weak recovery in America and faltering growth in China is now hitting hard the rest of the world, including Australia. Soon, Pacific islands will catch the contagion.

**End of the Mining Boom?**

The Australian economy, driven in the past by mineral exports to China, has grown slower. It grew at 3.7% in the second quarter as against 4.3% in the corresponding period last year. The decline in terms of trade has been responsible. The iron ore price fell by 34% from US$135 per tonne in July 2012 to US$ 89 per tonne in September 2012. Mining companies have postponed their investment and development programs, resulting in lay-offs.

So the RBA decided to watch and maintain the same rate. If things get worse, there would be a cut next month.

The RBF in a press release, says that “global growth outlook remains clouded by underlying problems in the Eurozone and the associated flow-on effects on its trading partner economies and having picked up in the early months of 2012, growth in the world economy has since softened”.

**Limitations of monetary policy**

Price stability is the responsibility of central banks. They target low inflation as their goal. RBA’s target rate of inflation is 3%. RBF also aims at low inflation. However, no central bank could be mandated about the rate of economic growth, since fiscal policy, the driving force of economic growth, is the responsibility of the ministry of finance.

Yet, central banks and ministries coordinate their policies. At best, monetary policy is expected to be supportive of the economic recovery as it has to be watchful of inflationary pressures.

There are two aspects of economy. One, where goods and services produced are in real terms; and the other is where they are in money values. Money
is neutral with respect to the real economy. In the long run, changes in money affect only prices, not goods and services in real terms, although monetary policy does affect real variables the short run.

However, recent experiences have shown that the east money policies in the US, UK and Europe have met with limited success, even in the short run. Already, interest rates are low.

Two months ago, politicians in Australia clamoured for a large cut in interest rate. Stephen Kirchner of University of Technology Sydney Business School wrote that we cannot buy additional economic growth through monetary policy.

Obviously, real variables have remained unaffected.

Kirchner recalls the US economist, John Taylor’s findings that official interest rates are largely explained by the current and past state of the economy and that the remainder that cannot be explained is the discretionary component of monetary policy. And it is usually very small. Therefore, it is the economy that drives monetary policy. Not the other way around.

So, when will the recovery begin?

Only when business confidence, a real variable, returns.
At no time were the challenges faced by central bankers greater than the ones faced in the past few years. The challenges are due to extraordinary circumstances created by the global recession.

Under a fixed exchange rate regime adopted by Fiji, maintenance of international reserves at a desirable level of around four to five months of imports is critically important. With foreign reserves reaching a record level at F$1.1 billion, which are considered equivalent to four months of imports, the Reserve Bank of Fiji (RBF) took two major decisions after its Board of Directors meeting in late November 2009.

One related to relaxation of foreign exchange controls. For example, effective 1 January 2010, the limit for individuals travelling overseas has been revised upwards to F$10,000, as compared to F$5000 previously.

Exchange controls were imposed in April 2009 to meet an unprecedented decrease in foreign reserves. As these controls proved effective in fully serving the purpose behind them, the RBF relaxed them.

The goal of economic recovery has now become more focused. Effective 1 September 2009, RBF removed credit ceilings that had been imposed in December 2006 following the overheating of the economy in 2006, when there was a credit boom leading to fast depletion of foreign reserves.

**Interest Spread**

Another major decision taken in the November 2009 board meeting was on lending rates. Effective 1 January 2010, the restrictive lending rate policies were also removed, keeping intact the spread of four percent between lending and deposit rates.

Earlier, following the rise in net foreign assets, there was an increase in liquidity in the banking system as well. The RBF felt it appropriate to raise the statutory deposit ratio in December 2009 to 7 per cent from 5 per cent of deposit liabilities.
An IMF Mission, at the end of its visit to Fiji in late November 2009, noted the departure from the usual approach for mopping up liquidity by selling RBF notes.

If we look at the central banks in advanced economies, there are striking differences between New Zealand and the US, which is still under recession, and Australia which is the only industrial country coming out of recession. While Australia raised its indicator interest rate as a preemptive measure to fight inflationary tendencies, the Reserve Bank of New Zealand (RBNZ) and the Federal Reserve (the Fed) in the US decided to hold on to the current indicator rates of zero to 0.25%

The Challenges

In the see-saw of bilateral exchange rates, the Kiwi dollar was appreciating against the US dollar, hurting its dairy and other agricultural exports, as well as tourism. The leader of the opposition Labour Party wanted an end to the 20-year bi-partisan accord on monetary policy targeting inflation. He urged the RBNZ to give up its anti-inflationary bias and resort to a loose monetary policy. A cheap monetary policy would depreciate the exchange rate. He argued that RBNZ’s policy targets did not help exports and growth.

In the US last week, the Fed came under severe criticism when Chairman Ben Bernanke sought confirmation to a second term. His opponents in the US Congressional Committee were vocal that the Fed failed to manage the economy. The critics blamed the Fed for creating the financial crisis by easy monetary policies and lax supervision of banks.

Bernanke’s supporters were arguing that his crisis-response is restoring financial stability and the crisis was caused by errors committed by previous Chairman, Greenspan. Bernanke succeeded Greenspan in February 2006. The critics, however, argued that like Greenspan, Bernanke did nothing to curb the rising real estate prices. Defenders say that Bernanke moved very aggressively to exert government power and use all the tools at his disposal once the crisis began.
Curbing the Fed’s Independence

The US Congress wants to introduce an audit system to control the Fed. The defenders are worried that it would destroy central bank independence. In his Senate testimony, Bernanke was against the idea of new audits on the Fed’s monetary policy, saying the Fed is transparent about its overall balance sheet.

No doubt, a recovery may be in sight. More importantly, when and where are the jobs going to come back? Bernanke faces great anger for bailing out banks. Americans are under the crush of high unemployment, stagnant incomes and rising foreclosures.

Yet, there is no alternative. President Obama, a Democrat, decided to give another term to Bernanke, a Republican. Perhaps he would have recalled President Theodore Roosevelt’s memorable words:

“It is not the critic who counts; not the man who points out how the strong man stumbles or where the doer of deeds could have done them better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood, who strives valiantly.”
The job of a central banker is not easy.

A central bank’s vision is long term oriented: growth with stability. Governments, on the other hand, being periodically elected, are myopic. More concerned with short term gains, they have an eye on the next election. In countries with strong traditions of respect for central bank independence, one would not expect the central bank and government to think and act on the same lines all the time. If any central bank action pleases the government of the day, the reasons would be purely coincidental.

On 6 August, the Australian central bank cut its benchmark interest rate from 2.75 percent to 2.5 percent to help boost economic activities. The cut was expected. The economy was under a serious threat of economic downturn following the imminent end of the mining boom. Earlier, the Australian government reduced growth forecasts with a warning that unemployment in the country would increase.

The rate cut came two days after the election date of 7 September was announced. The government was no doubt pleased with the central bank action. The opposition welcomed the interest rate cut but was keen to attack: “If interest rates go down, it is because this government is presiding over an economy which is in much more trouble than government has previously been prepared to admit.”

Will there be another cut?

The next meeting of RBA is on 3 September, four days before elections. Some economists are arguing that since growth is slow and the inflation outlook still benign, RBA might allow another cut.

This is not the first time that an interest rate change pleased Labour leader Rudd during an election time. In 2007, on Melbourne Cup day, just about three weeks before the elections, RBA hiked the interest rate to 6.75 percent. It was a big blow to Prime Minister Howard. Rudd was the opposition leader.

This time, the government is headed by Rudd.
Pundits ask us to carefully read RBA’s 6 August statement announcing the interest cut. It is not the same as the policy speech of RBA Governor Stevens some ten days ago. This time, it is less dovish. In his July speech, RBA Governor hinted that scope existed for further easing, if required. In the latest statement, it is different: “The Board will continue to assess the outlook and adjust policy as needed to foster sustainable growth in demand and inflation outcomes consistent with the inflation target over time”.

So, one cannot be sure of another cut in September.

Already, the Aussie dollar has declined to around US$0.89. The inflationary impact of depreciation is uncertain. The banks are expected to pass on the full reduction to borrowers. Any further cut in September has to be determined based on another assessment. One thing is certain: RBA would act on its own.

**Tussle in Thailand**

Now we shift to Thailand, the second largest economy in Southeast Asia. A tussle is brewing between the central bank, Bank of Thailand (BoT) Governor Prasarn and Finance Minister Kittirat. The BoT is worried by the mounting household debt. In an economy with a growing middle class using their plastic cards generously, easy monetary policy is the culprit. Furthermore, populist stimulus measures including subsidy to first-time car buyers and cheap housing loans have created a credit bubble.

Thai’s household debt is 80 percent of GDP, which was only 45 percent ten years ago. As the economy slowed down in recent months, households with reduced incomes face repayment problems. Monthly debt payments have soared to 34 percent of their monthly income.
Pressures from government

Faced with economic downturn, but reduced the policy interest rate in May by 25 basis points to 2.50 percent. Since recovery is slow, Minister Kittirat wants another cut. Governor Prasarn, citing the credit bubble, is resisting the pressures.

The Minister’s argument is the debt is “not too high. If banks are worried about bad loans, they should be careful about lending. So there won’t be any problem.”

The debt-servicing burden, with falling disposable incomes and rise in joblessness, would leave households with little cushion to absorb income shocks. The only way out is to cut down consumption. That would only worsen economic growth.

The Thai central bank governor knows that in the years just before the 2008 financial crisis, household debt was at its peak in rich countries. It was 175 percent of disposable income in Britain, and 140 percent in America. He wants Thailand to be spared from such a crisis.
In May 2014, the business world was taken by surprise by an unusual monetary policy decision.

The European Central Bank (ECB) for the 18-member countries of the Eurozone decided to charge a negative interest rate of one percent on deposits over and above the statutorily required reserves kept by commercial banks (banks).

A negative interest rate means that banks, which have excess liquidity, have to pay a fee of one percent for parking their funds at ECB.

**Statutory reserve deposit ratios**

Banks, by lending, create deposits in favour of borrowers, thereby increasing money supply. Monetary authorities enforce certain proportion of banks’ liabilities, mostly deposits of individuals, business houses and institutions be kept with central bank. Known as statutory reserve deposit ratios (SRDRs), they inspire confidence in the banking system by ensuring not all deposits accepted by banks are loaned away for interest rate income.

The SRDRs were used as monetary policy tool as well for reducing or expanding money supply. A higher SRDR would leave less of reserves with banks for lending, and vice versa. However, in modern days, central banks use indirect, market oriented tools and rely less on SDRS. Recognising SRDRS work as a tax by denying banks interest income and banks do keep reserves to meet unexpected withdrawals, Australia, Canada, New Zealand, Sweden and England have discontinued SRDRs.

In our region, 6 island countries with independent currencies do have SRDRs. For example, Fiji and Vanuatu have SRDRs of 10 percent and 7 percent respectively.

The US Federal Reserve and ECB have SRD ratios at 10 percent and 2 percent respectively. However, these two central banks were paying some interest on the reserves, a practice Fiji had also adopted for a while. In Fiji, the rate of remuneration interest on reserves was fixed at 50 basis points below overnight policy rate (OPR). Fiji’s current OPR is 0.5 percent and
hence the rate of interest for remunerating bank reserves with the central bank, is zero percent.

**Reason behind ECB move**

The Eurozone has had negative growth for two years: minus 0.6 percent in 2012; and minus 0.4 percent in 2013. Inflation in Eurozone which was 0.7 percent came down to 0.5 percent in May.

During recession with falling prices, banks are hesitant to lend as they are not sure about the return of the borrowed funds. Their fears are based on the pessimistic climate aggravated by deflation.

During deflation, profits decline. Consumers postpone consumption waiting for a further fall in prices and delay borrowing for auto loans and housing. So, banks in Eurozone keep their excess reserves with central bank as a safe place for them.

For fighting deflation and for boosting economic activities, last week ECB cut benchmark interest rate to a record low: 0.15 percent from 0.25 percent. Also announced was a €400 billion package of cheap funding for banks at cheap rates for loans to manufacturing companies.

Short of steps of the kind adopted by the US Federal Reserve, known as quantitative easing, for pumping money each month by purchasing bonds, ECB has been doing all that it could do.

What surprised the business world was its move to tax the banks at the rate of one percent on excess reserves kept idle with them. The negative interest rate is expected to act as a disincentive and make banks lend more.

**Will it work?**

Forcing banks to lend out their excess liquidity is not new. Two Scandinavian central banks experimented with a negative interest rate. Although the Swedish central bank introduced it in 2009, it was not implemented. In July 2012, Denmark bank began to charge a negative official interest rate.
The purpose was different from what ECB has in mind. It was to discourage inflows of funds which were strengthening the Danish currency, since Eurozone investors facing low interest rates were seeking higher returns in Denmark.

The negative interest rate worked for Denmark. Funds flowed out and the currency weakened.

The ECB’s objective is to fight deflation. No doubt, a weakened euro will promote exports. Imports will become more expensive. That will feed inflation. After all, ECB’s objective is just that!

The big question still remains: Will there be a higher lending?

The Danish experience showed that the effect on the real economy was zero.

So, that will only lead to one avenue left: quantitative easing of the kind the US and UK adopted: pumping in money each month. It has stopped deflation, although recovery is slow.

The latest news from UK is: housing prices are soaring. The IMF has issued a warning of credit bubble. That is another story!
“America and England are two nations divided by a common language.”

That was a humorous quotation, once dubiously attributed to Sir Winston Churchill.

In fact, it was Oscar Wilde who wrote in 1987: “We have really everything in common with America nowadays except, of course, language.”

Anyway, events have shown that both America and England continue to have many things in common, including the new, desperate search for external markets to compensate their inadequate, falling domestic demand to maintain and create jobs at home.

As US President Obama with a big team of officials and 200 American CEOs, completed his four-day visit to India on November 9 2010, British Prime Minster Cameron flew into Beijing with four cabinet ministers and 43 business leaders for his own wheeling and dealing.

**Obama’s India Trip**

Weakened by the US midterm election results, which led to the loss of majority for his party in the House of Representatives and to a reduced majority in the Senate amounting to a rejection of his policies to fight recession, Obama made it clear that the purpose of his India visit was to create jobs in USA. That did not go down well initially with the Indian political parties, as they recalled his campaign rhetoric against outsourcing of skills from India.

His first day in Mumbai was to his liking. He obtained a fresh order for $10 billion in new trade deals expected to create 54,000 jobs back in USA. Deals included transactions involving General Electric for aircraft engines and gas turbines, Boeing for 737 passenger planes and a $4.5 billion sale of C-17 military transport planes.

It was also indicated that there would be measures to ease export controls, imposed after India’s nuclear test in 1998.
India-US had trade of $36.6 billion in 2009-10. The objective is to double US exports to India over the next 5 years.

As the visit proceeded over the next two days, Obama began to say “right things at right places” that endeared him to his audience. College students cornered him with questions on his position on terrorism and the origin of terror attacks on India. They got the replies they wanted. In his address to the Indian Parliament, he extended support for India’s permanent membership in the UN Security Council, which of course drew prompt disapproval from the expected quarters, including Japan and Germany.

**Cameron’s China trip**

As Prime Minister Cameron arrived in China, news of China’s trade surplus in October greeted him. October exports rose to $136 billion, while imports were $109 billion, resulting in a trade surplus of $27 billion, just behind the year’s high of $28.7 billion in July.

British goods currently accounted for only 2% of China’s imports and Cameron was keen to raise it to 10%.

His first stop was the British owned Tesco supermarket which has 99 outlets and is planning a £2bn investment over the next five years.

An agreement was also signed for promoting export of British breeding pigs to China. The deal is valued at about £45m to the British pig industry over the next five years. To pork was also added some booze: the deal was reached to ensure only whisky produced in Scotland would be marketed in China as Scotch, which will increase sales by tens of millions of pounds.

Further, the British engine maker Rolls-Royce obtained a $1.2 billion contract for supplying a Chinese airline with Trent 700 engines for 16 Airbus A330 aircraft together with a long-term servicing contract.

There were pressures from home: Only trade? How about this year’s Nobel Peace Prize winner, now imprisoned in China for next 11 years? Pressure
from home, made Cameron to speak out at Peking University, but it was the occasion to say “wrong things at wrong places.”

He spoke on the need for China assuming greater international and domestic responsibility commensurate with its rise in economic prosperity. While he did not mention the Nobel Prize winner, his speech certainly referred to human rights.

Peking students, closely supervised by the military, were very different from the ones Obama met in Mumbai’s St. Xavier’s college. One student stunned Cameron with his question: “Why do you, the leaders from the West, often come to China for lecturing on human rights?”

**On to Seoul**

The leaders of 20 countries (the G20) are now in Seoul to save the world from economic crisis.

Each would be looking to its own survival first, before extending a hand to the drowning person. The competitive devaluation for promoting exports has been widely condemned: unsurprisingly, first from those who have enough trade surpluses: China and Germany. They were joined by Latin American countries led by Brazil. They fear that the US Federal Reserve’s addition to the money supply of another $600 billion through buying long term bonds during the next six months, would make the return on US dollar denominated assets unattractive and dollar funds would flow to emerging countries. In the process, their currencies will appreciate, hurting their exports.

The Indian Prime Minister, however, assured the US President at a joint press conference that he has no objection to the US Fed’s quantitative easing.

“A strong, robust, fast-growing United States is in the interests of the world,” said Prime Minister Singh. “And therefore, anything that would stimulate the underlying growth and policies of entrepreneurship in the United States would help the cause of global prosperity.”
That must have been music to Obama, a change from the discordant notes he was hearing from Europe, Latin America and Japan. Prime Minister Singh, a trained economist, welcomed the inflow of both hot money and long term dollar funds flowing into India in search of higher return. India wants capital inflows.

Appreciation of the Indian rupee would not matter, as Indian growth was not export-led in the past in any case but been domestic demand-led growth all along. In fact, any currency appreciation would make imports cheaper!

More suggestions, more confusion

In a more desperate move, US Treasury Secretary Timothy Geithner went to the extent of suggesting targets of current account surpluses at not more than 4%, knowing well that China’s trade surplus is 5% of GDP. His earlier suggestion of up valuing the Chinese currency had already fallen on deaf ears! Geithner later withdrew the suggestion of capping current account surpluses.

Not satisfied with the prevailing confusion, World Bank President Zoellick made his own contribution: bring back the gold standard! Of course, not in the same old way. He does not advocate rigidly fixing the value of currencies against the price of gold. He wants a future system of flexible exchange rates that should reference gold, instead of the US dollar, as a common point of valuation. If Zoellick’s suggestion is adopted, trade surplus countries including China would not rely on US dollars alone, but buy gold and other currencies to build up their reserves.

The G20 leaders are left in the midst of all these confusing signals to see what they can achieve.
It was to be another usual, uneventful Tuesday on 5 March 2013 at the New York Stock Exchange (NYSE). When business opened, no one expected anything sensational.

The squabbles among politicians were continuing in the face of mandatory spending cuts of US$82.5 billion which began from March 1, with an ultimate total of US$1.2 trillion over 10 years. President Obama had warned of the harmful impact of cuts in government services ranging from education, vaccines for children and medical research to airline travel and aviation security. The Republican opposition led by Senator Mitch McConnell dismissed the warnings as empty threats: “I don’t believe the world will end.”

With the housing market improving, the stock market roared back: Enough is enough.

The unexpected finally happened during the latter part of the day.

A single day record

New York’s Dow Jones share index set a new, all-time high record. In one day, it wiped out the losses brought on by the global financial crisis in 2008. It was at its highest (14,285) during the day, smashing the previous record intra-day high of 14,198 in October 2007. The index more than doubled (the lowest was 6,550) in the depth of the crisis in March 2009.

It closed slightly lower at 14,256.

The Financial Times and London Stock Exchange (FTSE) index also closed on Tuesday at its highest, 6432. The rise was 68 percent from its lowest in 2009.

For a second day, on March 6, the Dow Jones Index climbed further reaching 14,296.

At the close of business in NYSE on Thursday, the Dow Index has set a closing record for the third straight day, finishing at 14,329.49.
The Dow Index covers only 30 stocks. They include Coca-Cola, Microsoft, Wal-Mart and General Electric. The Standard and Poor is broader and NASDAQ is tech-heavy. They too rose, but not to the same extent.

Some exuberance is better than no exuberance! It has yet to become “irrational” to move the economy!

**Helicopter Ben**

Efforts by the US Federal Reserve (the Fed) to pump in money under the unorthodox program of quantitative easing (QE) have shown some results.

The QE was compared to throwing money from the helicopter. That earned the Fed Chairman Bernanke his nick name -- Helicopter Ben!

The best results would have been a rise in credit flows. Banks are hesitant although they are sitting on mountains of reserves.

The Fed has added more than US$3 trillion of monetary stimulus and US$1 trillion of bailout loans to financial firms since the 2008 financial crisis.

Just a week earlier, in late February, Chairman Bernanke told the US Congress that he would continue the QE until the unemployment rate is brought down to 6 percent, “which would be around 2016.”

The investors took the hint.

They decided to take out their cash from under their mattresses and buy stocks. Bond holders were dissatisfied with a poor yield of 1.9 percent on a 10 year bond and switched to stocks. Bond prices fell and equity prices rose. The job market news also played a role. A payroll data survey by Fortune 500 revealed that companies added 198,000 new workers to their payrolls in February. It was likely the current unemployment rate would fall to 7.8 percent from 7.9 percent.
Accommodative monetary policy

Central banks all over the world follow expansionary monetary policies.

On Tuesday, Fiji’s Reserve Bank announced no change in the overnight policy rate of 0.5 percent. Fiji’s economy is marked “by weaker performances in tourism, sugar, gold and sluggishness in electricity and cement production” and supply-side disturbances, which included cyclones in late 2012.

The European Central Bank decided on March 7 to keep the interest rate unchanged at 0.75 percent for the eighth month in a row. The Bank of England’s rate also remained unchanged at 0.5 percent.

Hopes are now pinned on the stock market.

A rise in stock prices enhances paper wealth, raising the value of collaterals. Borrowing by households rise and consumption and purchase of semi-durables goes up. Firms can raise more capital by issuing new stock at higher prices. The so called Tobin’s “q theory” speeds up monetary policy transmission.

Will QE lead to inflation?

Chairman Bernanke told the Senate Committee: “It’s our view that there’s still a good bit of slack in the economy. I don’t think the economy is overheating.”

That meant the Fed would not pull away the punchbowl but would be refilling it for a very long time!

And that meant the much awaited return of the asset bubble.
Can monetary policy replace fiscal policy for growth and creation of jobs?

Public works such as roads and bridges, and social infrastructure projects such as health and education need heavy outlay. They usually result in budget deficits that contribute to increase in outstanding debt stock. If some of them fail, it would be nothing but a disaster, as it happened in America recently. Two projects, one in solar energy and another in public transportation aimed at job creation were an embarrassment to US President Obama, now facing re-election.

When recession struck the industrial countries, only a few of them had enough fiscal space built over a period of years before the crisis. The US had to fight wars in Afghanistan and Iraq, giving rise to annual deficits and debt. When President Bush left office, the national debt was close to US$10 trillion.

In the current context of poor consumer confidence and uncertainties, policy makers all over the world, are perplexed. They are looking for solutions to get over the recessionary conditions.

**Choice is clear**

There is no other way to fight recession except through reviving demand and business confidence. Two options are left: fiscal policy or monetary policy or a combination of both.

In America, the Republicans are against big government. They oppose fiscal stimulus and taxes on the rich. They point out to the mounting public debt: national debt during the Obama years is close to US$16 trillion.

With elections scheduled in November, the US legislature is deeply divided. In the absence of a compromise, the so called fiscal cliff, namely automatic spending cuts and rise in taxes, would take effect.

In lieu of fiscal stimulus, monetary stimulus is resorted to by America’s
debt of US$23 billion of mortgage bonds in September and then US$40 billion in purchases each month for adding to money supply until the employment situation improves and as long as inflation remains in check. The dual mandate of price stability and employment creation enables the Fed to undertake these measures. The only questionable point is buying private sector debt. The Republicans say it is political and they are not happy with Fed chairman Bernanke.

Since benchmark interest rate is already low, 0.5% in USA (and in UK; 0.75% in the Eurozone; and 0.5% in Fiji), the only way open to monetary authorities is to add to money supply. Fed has been doing it in two rounds since 2008 under quantitative easing: US$1.7 trillion in the first round during November 2008-March 2010; and US$600 billion in the second round during November 2010-June 2011, in all for a total of US$ 2.3 trillion.

In a recession, when the prices of assets, including houses and commercial properties are falling, the value of collaterals for bank loans also falls. Banks were reluctant to lend despite the rise in their reserves. They were not sure whether they would get back their loans. Further, as the interest rate is low, banks have no attraction to lend out.

The Fed’s open-ended monetary stimulus is unique. If inflation creeps in, it will reduce real interest and the debt burden will go down; and the conventional transmission would start operating, including rise in stock prices, increasing paper wealth. Household consumption would go up. Inflation would also depreciate the US dollar, making US exports more attractive to foreigners.

The European Central Bank also decided to bail out the debt ridden countries by purchasing government bonds of unlimited amount in the secondary market and reduce interest rates, besides providing funds under a permanent funding arrangement known as European Stability Mechanism. Their objective is to save the euro. The member countries seeking assistance have to apply for and abide by conditionalities.
Not by monetary policy alone

It is well known that monetary policy changes take effect after lengthy time lags of 12 months or more. That is a serious handicap. Monetary stimulus can only play a supportive rule. It cannot be a substitute for fiscal stimulus. The Reserve Bank of Fiji recently revised the investment forecast for 2012 to be 18% of GDP, which includes private sector investments. Rightly, RBF’s Economic Review for August stresses the importance of public sector projects which are in progress.
The New York Stock Exchange (NYSE) Dow Jones index took an upward rise on 5 March 2013.

On Friday (Fiji time) and at the close of business in NYSE on 14 March, the Dow Jones index, which covers 30 major stocks, was on a winning streak for the tenth day in a row, similar to a string of advances seen in late 1996.

The wider S&P 500 and tech-heavy Nasdaq indexes also rose.

**Rise in aggregate demand**

The surge in stocks is due to three reasons: the United States (US) central bank’s decision to continue its easy money policy, including pumping in money until the unemployment rate is brought down to 6 percent; recovery in housing construction; and rise in corporate earnings.

The February US job report was also favourable. The private sector created an additional 236,000 jobs in the midst of the cuts in civil service. The job report is now supplemented by yet another upbeat report on increase in retail spending. The rise in consumption was 1.1 percent from January to February, despite the discontinuance of payroll tax cuts from January.

About 70 percent of American aggregate demand is consumption. As they say, one man’s expenditure is another man’s income. Increase in demand is good for the economy, as long as the inflation outlook is benign.

The consumption increase covered a wide range of goods: from automobiles to furniture. In addition, the businesses added to stocks as well. The addition to inventories reflects business confidence that demand would continue to be on the rise.

**Fiji’s economy**

Reserve Bank of Fiji’s economic review for February 2013 was equally upbeat. Increase in new consumption lending last year by 25 percent by banks and rise in sales of new vehicles by 40 percent in January 2012
are good news. Domestic consumption was expected to pick up in 2013, supported by “the flow-on effects of the reduction in personal income tax rates, the implementation of the government minimum salary of $10,000 per annum and the 10 percent wage increase across the board for wage earners”.

Another piece of encouraging news is on investment, expected to reach 25 percent of GDP in 2013.

Bank lending to real estate and building and construction sectors also registered increases.

Domestic cement sales, which rose slightly in 2012, were expected to increase as a number of construction projects were planned for 2013. The inflation outlook continued to be benign, falling to 2.4 percent in February from 3.2 percent in January.

**Monetary stimulus**

Only Australia has been fortunate. Its external sector is booming, thanks to China, which energises the Australian economy by its insatiable demand for minerals.

For less fortunate countries, some stimulus is needed. To step up demand, almost all central banks, including Fiji, are on an expansionary path.

Policy indicator interest rates of central banks of the US and United Kingdom (UK) are at the lowest: 0.5 percent. They are also adding to money supply by purchasing government and private debt, known as quantitative easing. They were joined by the European Central Bank (ECB) in 2012. The ECB’s interest rate is 0.75 percent and it bought government bonds to save the euro.

The latest to adopt the quantitative easing is Japan. Prime Minister Shinzo Abe wants the central bank to print “unlimited amount money” to get out of deflationary conditions and speed up the recovery. He also wanted the Bank of Japan (BOJ) to raise the inflation target rate to 2 percent. The new BOJ
Governor will be soon resorting to quantitative easing of unprecedented proportions.

**Cockroach ideas**

Leaders in Europe and UK are for austerity. Keynesians argue that in a depressed economy in the liquidity trap, monetary policy alone will not work. To them, austerity is anathema in the midst of economic misery.

Nobel Laureate Paul Krugman in his New York Times blog accused Europe’s fiscal enforcer, Commissioner for Economic and Monetary Affairs, Oli Rehn, of pursuing a “Rehn of Terror”. Krugman calls blind adherence to a policy of austerity as “clinging on to cockroach ideas: those that keep coming back no matter how hard you try to flush them away”. He describes cockroach ideas as misconceptions because “the people holding them are just unaware of basic facts.”

Referring to UK as “Osbornia”, he warned against the “self-defeating policy” of British Chancellor of the Exchequer, George Osborne, who is making deeper cuts to hit an official debt-to-GDP target. Krugman and other Keynesians argue more public spending, not austerity, is needed.

The Archbishop of Canterbury and other 43 Bishops, who are not economists by training, in an open letter protested the government’s plan to cap annual rises in welfare benefits at 1%, regardless of the rate of inflation.
The global economic downturn since 2008 has now affected island nations and neither size nor location matters.

In the Pacific, we hear Tonga (population: 106,000; land area: 717 sq. km; GDP: US$816 million) is in bad shape.

From the Caribbean, we hear that the International Monetary Fund (IMF) will approve a multi-million dollar Stand By Agreement with its usual belt-tightening measures to a much larger and mineral resource rich but crisis-ridden Jamaica (population: 2.9 million; land area: 10,990 sq.km; GDP: US$ $13.8 billion).

Tongan economy

National Reserve Bank of Tonga (NRBT) Governor Mafi told the business community on 30 January 2013 that the economy is not doing well. She observed: “We are part of a global economy so the development in the international market and economies will definitely affect us here in Tonga, and we are still suffering from the spill-over effects from those economic developments internationally from the impact from the global finance crisis.”

Tonga’s exports, mainly agricultural products: squash, vanilla beans, fruits and vegetables and fish, are decreasing. Tonga’s manufacturing capacity is insignificant compared to Fiji with no strong import substitution possibility.

There is also a decline in inward remittances from Tongans working overseas. Remittances in 2008 were US$123.2 million. They fell to US$63 million in November 2012. Tourism receipts were inadequate to offset the decline in export earnings and remittances, as the number of tourist arrivals during the previous nine years has been stagnant.

As domestic investors are hesitating to borrow in a contracting economy, banks have excess liquidity. Further, there is a rise in non-performing loans as well.
Tonga’s public debt is 45.1 per cent of GDP, above the internationally prescribed threshold of 40 per cent. External debt is 90 per cent of total debt and China is the major lender. Repayments were due to begin soon and would amount to 18 per cent of public expenditure in 2013. They will result in cuts in essential services.

The IMF has declared Tonga’s economy at a “high risk of external debt distress”.

**Jamaica**

On February 12, the visiting IMF Mission confirmed that Jamaica would be seeking another round of a multi-million dollar Standby Agreement (SBA) for getting out of the debt trap it created for itself over a decade.

A 27-month SBA worth US $1.27 billion expired in May 2012. In fact, it lapsed after the previous government was unable to meet performance targets set by the IMF.

Jamaica is lucky with mineral resources. The bauxite-alumina industry with foreign investment has shifted its dependency on sugar and bananas. It is a leader in the export of minerals.

What went wrong were the fiscal excesses year after year, since 1962, resulting in the build-up of public debt. Today it is J$1.7 trillion or US$18 billion (130 percent of GDP). The Chicago Tribune called Jamaica, “The Greece of the Western Hemisphere.”

More than 50 percent of its budget is now devoted to servicing its loans and only 20 percent is spent on health and education programmes.

All the credit rating agencies have described the outlook as negative. The statement by IMF Mission Chief Sums up the situation: “The Jamaican economy has experienced very low economic growth, declining productivity, and reduced international competitiveness. An important factor behind these problems has been Jamaica’s unsustainable debt burden, which has
undermined confidence and elevated risks to economic stability”. Before seeking the second round of IMF assistance, Jamaica tried to restructure its loans to stretch them out over more years, at lower interest rates, with no success. Under the new IMF assistance, there are pre-conditions:

- eliminate discretionary tax waivers
- freeze wage levels to achieve a wage to GDP ratio of 9 per cent by 2015/2016
- pass a Public Debt Management Act;
- Implement a new debt exchange offer; asking bond holders to accept terms that will reduce debt to GDP ratios by 8.5 per cent.

Fiji’s competent macroeconomic policies

Fiji’s debt level is 51.5 per cent of GDP, having been reduced from 54 per cent from 2010. Even if government guaranteed debt is included, the debt level is well below 70 per cent of GDP.

Fiji was ravaged by three cyclones in 2012, the deadliest being Evan in the December. Unforeseen and unbudgeted expenditures to meet these emergencies impose a burden on public finances and policy makers are aware that they have to be met with prudent measures.

Recognising Fiji’s competent fiscal management, on 14 February 2013, Moody’s Investors Service upgraded the government’s foreign and local currency long-term bond ratings to stable from negative. Better policies and improved outcomes are responsible for the favourable rating.
The earthquake of 11 March, which rocked Japan, shook the world too!

Although Japan was beaten by China in early 2011 to third place in the list of world’s largest economies, it still ranks as one of the world’s most innovative nations. High productivity based on admirable work ethics and technological superiority made Japan leap forward in the post-war years.

The vivid images on TV of the way the citizens conducted themselves with such high standards of discipline and stoic courage will never be forgotten. Economic historians have written volumes about how the resilient Japanese recovered after the 1923 Kanto earthquake that devastated Tokyo killing 140,000 people, and how Japan again rehabilitated itself two decades later when American B29s dropped atomic bombs in March 1945, killing 100,000 people in one night.

The undaunted Japanese with their disciplined attitudes to life, sheer persistence and hard work, made the country Number One in the 1970s.

So too, after the 1995 Kobe earthquake, which, besides killing 6400 people and leaving 300,000 homeless, caused damage estimated at 10 trillion yen (FJ$188.8bn), Japan recovered quickly.

**World Development Partner**

The post-war modern Japan committed to democratic values and became a natural partner with the US and the West. It has been playing a major role in world development. It is the largest donor to the Asian Development Bank, a multilateral bank. It has also emerged as one of the leading bilateral donors to developing countries, including Fiji and other Pacific island countries.

The latest disaster is a combination of three: the earthquake in the industrial areas, tsunami and destruction of power plants, followed by a nuclear meltdown with fears of radiation. This triple disaster has also come at the worst of times, in a world economic downturn of unprecedented proportions.
For Japan, whose economy contracted at the end of 2010, it is a big blow. Production has been totally destroyed in the north-east of the country, which suffered the brunt of the quake. The areas affected by the triple disaster contribute 4 per cent of the country’s GDP.

The companies affected include electronics giant Sony with six factories, Toyota with three plants and Nissan with four factories and Honda with two. Additionally, the port in the nearby city of Yokohama was also damaged.

Rebuilding the economy

The estimated losses are around 10-16 trillion yen (FJ$236-FJ$377 billion). As the estimates came in, the world stock market reacted: Japanese stocks suffered most, their worst, since the 1987 crash, losing FJ$1182bn in value before rebounding by 5.7 per cent.

A quick estimate by economists in the region suggested that in the short-term, the loss would be around 1 per cent of the country’s GDP.

A rebuilding exercise could help it balance out and turn positive in about 12 months. Past experiences have shown that rehabilitation work following major incidents had stepped up demand and helped the economy bounce back.

However, rehabilitation expenditure has to be incurred by the government, adding to its already large debt. Japan’s public debt is twice the size of its FJ$10.01 trillion economy, the highest ratio of any large developed country in the world.

But unlike debt ridden countries such as Greece, only 5 per cent of Japan’s debt is held by foreign investors. Hence, the risks of a funding crisis are limited.

Soon after the earthquake and tsunami, the central bank of Japan decided to pump in more liquidity. The Bank of Japan pumped in all 23 trillion yen (FJ$ 355 billion) into the country’s banking system for promoting investment by the private sector. While it was difficult to expect immediate
results from this, as the interest was low, symbolic efforts do matter.

Rise in the yen

As the Japanese public and insurance companies buy back their home currency in order to fund the country’s reconstruction, demand for the yen will go up. With massive inflows of contributions from families and friends overseas and aid money rushing in, the yen had already begun to rise. Soon after the Kobe earthquake in 1995, the yen soared to an all-time high against the dollar as Japanese firms pulled funds home.

The dollar plunged to 76.53 yen (FJ$1.877) in New York, far below the previous all-time low of 79.75 yen (FJ$1.95) set in April 1995. The rise in the yen’s value hurts exports from Japan.

Impact on nuclear energy industry

The explosions and meltdown of nuclear power plants caused widespread fears of radiation, as well as impacting the nuclear energy industry, causing European nations to do some re-thinking.

However, China and India announced they would go ahead with their nuclear energy plans. Nearly 40 per cent of India’s 1.2 billion people do not have regular access to electricity. India has 20 nuclear reactors and intends adding two dozen to increase power generation tenfold. China will add 10 new reactors a year to its 11 reactors.

Two companies in America, General Electric and Westinghouse, the makers of nuclear reactors, have no worries!

Implications for Fiji

Pacific islands, including Fiji, had to face in the short run some steep fall in tourist arrivals from Japan. The FDI flows to developing countries may also decrease in the short-run. However, a decrease in official assistance is not likely, as Japan will maintain its committed levels of aid programmes.
Japan will rise again.

Noting that Japanese culture has a long-prized fragility, impermanence and transience, Hugh Levinson of BBC observed that the cherry blossom is the most prized of all expressions of nature because it achieves such a brief perfection before falling.

At the same time, it is the flexibility, in the context of fragility, which gives greater strength to get up and go.

Levinson rightly recalls the Zen teaching which praised the way the bamboo’s flexibility gives it a special strength.
On 24 January 2014, at the World Economic Forum Meeting (WEF) in Davos, Switzerland, as the IMF chief Christine Lagarde was repeating her warning of the effects of falling prices in southern Europe, disturbing news trickled in: Argentina’s high inflation and its currency, the peso – had a big fall by 11 percent.

As this is written, more bad news! This time on the Turkish lira and the South African rand. All relate to high inflation in these countries with Argentina’s high inflation at 30 percent. Dr. Lagarde had to sound the warning on deflation at WEF meeting in Europe, which is in the doldrums.

Europe is growing only by 1 percent this year as compared to US, which is predicted to grow by 2.8 percent. With the US tapering its monetary stimulus, IMF wants Europe to step up demand since the Eurozone inflation is only 0.8 percent, well below the 2 percent target.

**Inflation elsewhere**

In contrast, inflation is raising its ugly head in other countries.

In Argentina, populist measures and bulging budget deficits, which are funded by monetization, have pushed up inflation. It is cheaper to mail order Chinese products delivered at the door step direct from China, than those bought at local stores. The resulting trade deficits caused decline in foreign reserves by 30 percent.

It was similar to India’s plight last September, when the Indian rupee fell by 17 percent. The US dollar appreciated and the domestic currency went down in value. The impact is also similar. Essential imports became more expensive, further fuelling domestic inflation. While Argentina’s inflation is 30 percent, India has been struggling with 10 percent inflation.

Before the authorities moved, consumers in Argentina and voters in India acted swiftly.

Last month, Argentina witnessed looting of supermarkets. In India, rise in onion prices from 9 rupees to 100 rupees per kilo cost the major partner
of the ruling coalition at the centre, with the party losing elections in four states and the capital city of Delhi.

India’s inflation

A committee set up by Reserve Bank of India (RBI) on monetary policy framework refers to six continuous years of inflation and its inability to deal with this problem. The reason is an apparent lack of autonomy. The central bank was persuaded by government to go soft on monetary tightening.

On Tuesday, January 24, the new RBI Governor, Raghuram Rajan, made clear his intention to be independent.

Much to the shock of businessmen and dismay of finance minister, RBI increased the policy indicator rate to 8 percent from 7.75 percent. Known as repo rate, it is the rate at which banks borrow short-term funds from the central bank. By monetary tightening, RBI aims at bringing down consumer price index inflation below 8 percent by January 2015 and below 6 per cent by January 2016. The ultimate inflation target is not more than 4 percent.

Rajan voiced the concerns of the common man when he explained the interest rate hike thus:

“Elevated levels of inflation erode household budgets, and constrict the purchasing power of consumers. This, in turn, discourages investment and weakens growth. High inflation weakens the rupee. Inflation is also a tax that is grossly inequitable, falling hardest on the very poor.”

Turkey’s currency, the lira, fell on January 29 by 16 percent against the US dollar. The reason: inflation was 7.4 percent. Turkey’s central bank raised its interest rate on overnight loans from 7.75 percent to 12 percent.
Inflation in the Pacific

ANZ monthly report says Fiji’s inflation was 3.4 percent in November, driven higher by food and beverages, which increased to 5.5 percent from 5.1 percent in October. Solomon Islands’ inflation is the highest at 6.3 percent. Contractionary policies over the last one year contributed to a decrease in inflation from 8 percent.

The news this Friday is that the American economy grew at 3.2 percent annual rate in the last quarter of 2013, confirming expectations that 2014 will be the best year since 2009. The US central bank has decided to reduce its bond purchases by another $10 billion. Therefore, addition to money supply in February will be US$ 65 billion, down from US$75 billion in January and from US$85 billion each previous month.

Emerging economies would experience another round of currency depreciation, as capital funds would flow back to USA. Already, India, South Africa and Turkey raised their interest rates to fight inflation. Hikes in interest rates will stabilise their economies too.
In a 1984 Hollywood comedy, Blame it on Rio, Michael Caine (playing the role of Matthew with past-marital problems) has an affair during his vacation in Rio De Janeiro with the teenaged daughter of his best friend, Joseph Bologna, and lays the blame for all his misfortunes on the vacation resort where the two families got together.

Since the world recession in late 2007, which was triggered by the American financial crisis, it has become fashionable for countries, small or big, to take the “Blame-it-on-Rio” route for conveniently hiding their economic failures.

Iceland

In late 2008, Iceland (population: 318,000 and per capita income: US$38,000), a country outside the Euro zone, got into financial difficulties that had nothing to do with the US financial crisis.

The Iceland economy was once propelled by fishing activities, however, its financial institutions wanted to spread their wings. They began to offer high interest rates to lure depositors from overseas but they could not manage the funds. Investments, mostly of the wild-goose-chase variety, failed and the news spread. The result was an unprecedented run on Iceland banks. As bank failures were imminent and the Iceland government could not come to their rescue, Britain had to issue a stern warning just short of military intervention to Iceland to shape up!

Prime Minister Gordon Brown’s anger was understandable. Senior citizens, UK civil service unions, and notably the London Police Credit Union, had put their funds in Iceland banks and were left high and dry.

An investigating commission looked into the crisis and concluded that the central bank and the government did not exert enough pressure on the banks to shrink their balance sheets. The banks had accumulated liabilities equivalent to 10 times Iceland’s output, a development the commission said was the key in fuelling the financial collapse. It was obvious Iceland’s troubles had nothing to do with American crisis; it was of their own making.
Greek tragedy

In early 2010, Greece (population: 11 million; per capita income: US$30,000), turned out to be a major embarrassment for the Euro zone. The future of the single currency came under severe scrutiny. It became clear that while a common central bank for 15 nations could control money supply and keep a single interest rate, it cannot control each member country’s fiscal policy and public sector.

Joining the Euro zone in 2001, Greece took the membership as a credit card for access to international markets, borrowing freely and adding to its external debt. No doubt the Greek economy boomed, the public sector expanded and corruption set in with increasing salaries.

When the global recession began to hit the world, Greece was ill-prepared to cope. It came to light that Greece’s budget deficit was 12.7% of GDP, more than four times higher than Eurozone rules. Its debt in April 2010 was 300 billion euros (US$419 billion) and 125% of GDP. Germany, the powerhouse of the Eurozone, was upset.

Did Greece really earn the Euro membership? Or did Greece gate crash the elite club? When the single currency was born on January 1, 1999 with 11 countries (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain) as members of a currency union, Greece was left out.

It had to wait for two years as there were some prerequisites to fulfil. The minimum qualifications for the exclusive club are:

• Inflation: no more than 1.5 percentage points higher than the average of the three best performing (lowest inflation) member states of the EU.
• Annual budget deficit: the ratio of the annual budget deficit to gross domestic product must not exceed 3%; and
• Debt: the ratio of government debt to GDP must not exceed 60%.

Greece was admitted to the club in 2001. There were allegations that Greece suppressed its debt figures and fudged its statistics right from the days it was first trying to join the elite club.
An oversized public sector and tax evasion caused the problems. They were nothing to do with the American financial crisis, which only compounded its difficulties.

One of the amusing limericks compiled by Wall Street Journal’s bloggers became a big hit.

“There are two indisputable facts
That toppled the Greeks on their backs:
Every third Greek today
Works for government pay,
And the rest are evading their tax”.

**Now to Ireland**

Ireland (population 6 million; per capita income: US$ 41,000), once one of the world’s biggest economic success stories, is now the new headache of the Euro zone.

Ireland has been a founding member of the Euro zone since 1999. The country that was long known for high unemployment, high taxes and high rates of emigration, emerged as the fourth most affluent country in Europe. With public sector and tax reforms since the 1990s, (its corporate tax was one of the lowest in the world), shiny towers rose over dusty old Dublin. Business and government leaders justifiably boasted of the strength of the Celtic Tiger.

Then, came the bust brought by banking excesses. Ireland had to bail out its most famous bank, the Anglo Irish, whose real estate loans landed it in a national crisis.

The total cost to the government to fix the banking system was estimated to be close to 30 percent of overall economic output. The banking problems were not new. Years of property speculation, fuelled by loose low interest rates, set by the European central bank and actually
meant for the needs of the bigger economies including Germany, was the culprit.

Ireland, being a Eurozone country, had to fall in line.

Low rates of interest had given rise to a boom in the property market, which collapsed.

Ireland experienced a fully-fledged banking crisis, leading the government to guarantee the liabilities of the other major banks, as well as the Anglo-Irish bank.

Bad real estate debts resulted in the country’s debt of about 110 percent of national income. Thus Iceland, Greece and Ireland had their own crises. All were home grown, although their difficulties were compounded later by the on-going world recession.

**Every crisis has a lesson**

During good times, banks lend generously to all, including those who should not have been borrowing on the scale they did. The lesson is that prudent lending is the need of every hour.

In the USA and elsewhere, including Fiji and the case of National Bank, banks were reckless about lending to individuals on demand. They sanctioned mortgages to a multiple of several times applicants’ income, and to a value greater than that of the home they sought to buy.

New pressures on banks began building up.

Banks are now required to lend more to small businesses and first-time businessmen. If lending is restricted to creditworthy people, we have learnt a lesson.

If it exposes borrowers to unsustainable levels of debt, it would mean we have forgotten what we learnt.
Instead of ending on a dreary note, here is a limerick contributed by Dr. Goose to the Wall Street Journal.

“The credit crunch left deadly traces
On banks found in high and low places;
The research clearly shows,
As many suppose,
Loans on homes were to blame in most cases”.

Two news items hit the headlines in the last week of August 2012.

One was about falling commodity prices and their likely adverse impact on commodity export dependent Pacific island countries (PICs). The other was about rising prices and their favorable impact on growth and incomes of farmers.

How could inflation be good for growth? Is it not bad for consumers? Are inflation and growth compatible? Let us check the first news item in detail.

**Falling price level**

The Pacific Quarterly Report issued by ANZ Bank said lower commodity prices are hurting PICs. World prices of palm and coconut oil, sugar, cocoa, coffee and rice had been falling in the first half of 2012 and were expected to fall further, except for a rise in rice prices, which levelled off. So too prices of minerals, including gold and crude.

The resource-rich Melanesian country, Papua New Guinea, which exports gold and oil and non-mineral agricultural commodities including coffee and cocoa, and Solomon Islands, which exports palm oil, would be adversely affected. Their export earnings would decline if export prices fell.

Polynesian countries would also suffer. Samoa and Tonga are dependent on coconuts and related products. Thus, PICs producing hard and soft commodities would be badly affected if their export prices declined as against prices of manufactured imports.

The economic jargon is terms of trade. If the ratio of export price index to import price index declines, it takes an adverse turn. The country’s growth would be hit hard. If agricultural output prices fall, agricultural incomes fall. Reduction in farmers’ incomes raises the poverty level.

**Rise in farmers’ incomes**

The other news item was from India, where a federal government minister said, “Dhal, wheat, rice and vegetables have become expensive. The farmer
will gain profits from this and I am happy with the rise in prices”. That touched off a firestorm of criticism.

When confronted by the press, the minister retorted: “Rise in food plate is benefiting farmers...And the government is in favor of farmers’ profit”. That was sufficient for the opposition parties. There was a call for resignation of the minister.

“Is inflation injurious to the economy?”

Inflation reduces the real income of the people. Fixed income earners and pensioners would soon find their income buying less in goods and services than before. Consumers would pay more for their normal level of consumption. Their purchasing power would be reduced. Thus, inflation amounts to tax on income. Consequently, it reduces incentive to work or to save.

On the other hand, producers will be happy if prices rise, of goods they produce. Producers’ incomes would rise. Rise in income acts as an incentive. An increase in price brings forth more supply from the producers and they would work harder, bringing more area under cultivation.

If inflation is good for growth and also harmful to growth, is there any tolerable level? Economists are bothered about the threshold level of inflation. Studies by IMF economists showed the threshold level varies depending on the level of development. It was 1% to 3% for industrial economies and 11% to 12% for developing economies.

A study by University of the South Pacific economists says Fiji’s threshold level inflation is 3.6%. As long as the inflation level is below this threshold level, the effects on growth would be positive, but inflation at a higher level than 3.6% would adversely affect growth.

Close monitoring of the inflationary trends and timely control of the factors responsible for inflation, are critical. In addition, it is expedient to build up foreign exchange reserves in good times so they are available when they have to be spent on imports of staples in bad times. That requires prudent
fiscal and monetary policies. Above all, close co-ordination between the finance ministry and central bank is needed.

Dian Cohen, a Canadian radio and TV commentator famously remarked: “Having a little inflation is like being a little pregnant--inflation feeds on itself and quickly passes the ‘little’ mark”.

In the midst of a global slowdown with new fears in Europe, a budget exercise in an island economy supported only by tourism and agriculture, unlike in the mineral resources-endowed Papua New Guinea with booming exports, is indeed difficult.

The 2012 Fiji budget was a daring one, as it looked forward confidently towards strengthening the economy.

Fiji, which managed to bounce back from two consecutive years of contraction with a likely growth of two percent in 2011, was described by the recent IMF Mission as the best result of the past five years, with a growth estimate of 2.3 per cent for 2012, is well on track with measures of fiscal consolidation.

**Tax relief measures**

Mindful of a persisting lull in industrial production, a soft investment activity and modest consumption spending, in line with slow growth in private sector credit during the past few years, the Prime Minister and Minister for Finance has included measures to boost domestic demand in his budget proposals.

First and foremost, Government is aware that inflation in 2011 at seven per cent hurt low income groups. The budget measures amply provided much needed relief measures; this would contribute to stepping up domestic demand.

The income tax threshold in 2012 will increase from $15,000 to $15,600. For other income groups, the tax rate is lowered from 25 percent to seven per cent for $15,601- $22,000; from 31 percent to 18 percent for $22,001-$50,000; and from 31 percent to 20 percent for $50,001- $100,000. These tax relief measures measure “will put $53.1 million back in the pockets of Fijians.”

For encouraging private sector investment, the budget has announced a reduction in the corporate tax rate from 28 to 20 percent, which will give the corporate sector greater opportunities to extend and expand their
businesses.

For compensating the revenue loss and for equity purposes, the rich have been called upon to make their contributions. A Social Responsibility Levy will be applied on fully chargeable income, starting at 23 per cent for income tax band $270,001 to $300,000. The top one per cent will thus contribute an estimated $9.8 million to social welfare programmes through this Levy.

**Fiscal consolidation**

Other measures include Hotel Turnover Tax (HTT) renamed as Service Turn over Tax (STT), also applies to other tourism related services including rental car operators and other services. While there have been a few increases in fiscal duties on seven items ranging from canned fish to DVDs, there are 11 items on which fiscal duties have been reduced or eliminated totally. Notable are agricultural inputs and raw materials used for industrial production outside Viti Levu. Fiscal duty on fruits and vegetables not grown in Fiji would be reduced to five per cent from 32 percent.

“Sin” taxes, namely excise rates on various tobacco products and liquor have been appropriately raised upwards so that the “health” of the nation is promoted and protected.

While revenue measures are designed to give relief to lower income groups and encourage private sector investment, government is aware of the public debt position. Public debt is 55 per cent of GDP; and with contingent liabilities of more than 15 per cent of GDP and unfunded FNPF liabilities, it is around 70 per cent.

The budget has kept the 2012 deficit small. The estimated total revenue for 2012 is $1.9 billion while the estimated total expenditure is $2.1 billion. The gross deficit is estimated at 2.8 percent and the net deficit: $135 million or 1.9 per cent of GDP.

The IMF Mission has commended Government’s effort in keeping the 2011 fiscal deficit at 2.5 percent. Now with additional pruning, the budget deficit
is smaller than the recommended two per cent of GDP.

Finally, one thing which deserves mention is the close co-ordination of monetary and fiscal policies.

The Reserve Bank of Fiji has kept a very accommodative policy for encouraging investment. In late October, RBF reduced the benchmark interest rate known as Overnight Policy Rate from 1.5 percent to 0.5 percent, the lowest in recent years for providing “the environment needed to boost economic activity.”

So with proactive fiscal and encouraging monetary policies, it is time for the private sector to play its part. It should help lay, in the Prime Minister’s words, “the foundation of Fiji’s future, one that breaks with that which weighed down our past, yet builds upon the strengths of the Fijian people.”
A famous quote of Mark Twain is: “The only certainties in life are death and taxes.”

If the American humorist were back again in the 21st century, he would add one more to the list: “Debt”.

Debt dominates the life of the individual, whether young adult (credit card purchases); households (housing loans); or business firms (loans for operating and capital needs). Nations have become adventurous with overspending, “legitimate” or “illegitimate” and “responsible” or “irresponsible”.

Legitimate expenditures are on essentials: law and order and justice and protection of private property. The “illegitimate” expenditures are commerce and trading, which are best left to the private sector. Responsible expenditures are for provision of public infrastructure and clean air and potable water, and irresponsible ones are those such as military misadventures.

The latest instance is Greece’s behavior. Using the Euro club card, Greece borrowed heavily overseas. It breached the membership criterion: debt should not exceed 60 percent of GDP. Kierkegaard of Peterson Institute for International Economics indicted thus: “Greece is fundamentally a corrupt dysfunctional government that is unable to raise enough tax revenues to pay for its expenses.” The debt of Greece is 165 percent of GDP.

Debt in advanced countries

Japan’s debt is the highest: 205 percent. Next come Italy (120); US (102); France and UK (86); Germany (81); Spain (68); and Netherlands (65). Japan’s debt history coincides with that of the recession of the 1990s, which continued into the 2000s. Japan’s past budget deficits included a 2 trillion yen corporate bailout to assist weaker private sector companies. This practice is unacceptable in America. Republicans condemned President Obama’s bailout for auto industry, which turned out to be successful.

Remember the bumper sticker of US Vice President Biden:
Osama Bin Laden is Dead, General Motors is still Alive!

America’s public debt is US$11.4 trillion (72 percent of GDP). With the holdings of intra-governmental bodies of US$4.9 trillion, the total public debt is $16.3 trillion (102 percent of GDP). This is less than what it was when World War II ended in 1945: 113 percent, which decreased over the next 30 years.

The string of annual fiscal deficits commenced from 2001 when the war against terror began. Financing the Afghan and Iraqi wars is a continuous burden. In the latest fiscal year ending September 2012, the deficit is US$1.1 trillion (7% of GDP). By ending the wars and with no new international policing role, the US debt is controllable. President Obama avoided an active role in the Libyan liberation and relied on economic sanctions in the Iran crisis. With the fresh mandate, he will pursue his agenda of reducing the annual deficit through a rise in taxes on the rich and by effecting cuts in expenditures.

The strength of America in terms of productive resources and technological superiority makes the country a safe haven. Its debt is held by others, including China, which accumulated trade surpluses. The US dollar is the world reserve currency. The euro has yet to become a competitor. The rest of the world cannot expect that its debt will be held by others. If countries cannot service debts through their annual tax revenues, they become broke. Insolvency of a nation leads to devaluation of its currency with its attendant miseries.

The choice before Greece is limited. Quitting the euro and getting back to its old currency involves high adjustment costs of devaluation. So continue in the euro zone and survive with austerity measures.

Fiji’s Debt

Public sector debt comprises two components, domestic and external debt. Fiji’s debt level has fallen, from 56 percent (domestic: 47 percent and external: 9 percent) in 2010 to 52 percent (40 percent and external 12
percent) in 2011. External debt went up following the 2011 overseas bond. If we include contingent liabilities (debt of statutory agencies guaranteed by government) of about 15 percent, Fiji’s debt is 67 percent of GDP.

Fiji’s debt level is lower than the Indian Ocean countries (Mauritius, Seychelles and Maldives: 70 percent) and the Caribbean countries (80 percent). The concern is: how to contain it? The answer is fiscal sustainability. That hinges on: can Fiji smoothly finance its 2013 and future budget deficits without generating large increases in debt?

Fiscal sustainability is determined by the capacity to produce primary surplus: revenues minus expenditures. From primary surplus, interest payments are met. Producing primary surplus depends on controlling rises in operating expenses.

The 2012 budget gave huge tax reliefs. The corporate tax rate was reduced to 20 percent, with a substantial cut in personal tax rates as well. There may not be any further scope in tax relief, as the threshold level was also raised.

The focus will have to be on cuts in operating expenditures. The budget deficit, which was 3.5 percent of GDP in 2011, has to decrease further if the debt level has to come down to the targeted 50 percent level in 2013. Fiji’s 2013 Budget has to follow a lower fiscal deficit path.
Fiji made it

Fiji’s second international bond issue for US$ 250 million in March 2011 was fully subscribed. In fact, it was oversubscribed by midday, with the order book closing almost three times oversubscribed within 12 hours of the launch.

It is a clear indication of the recognition of Fiji’s credibility as a credit worthy nation. It also heralds a new dawn of opportunities and challenges for a nation that has been hit by shocks of all kinds since 2006, both domestic and external, including the on-going Great Recession since 2007.

The improvement in S&P’s rating of Fiji two weeks ago from “stable” to “positive” in regard to the level of international currency reserves, was a major factor in influencing overseas investors’ decisions. International reserves stood at F$1.3 billion at the end of January 2011. The reserves are equivalent to about four months’ imports of goods and services. This is due to reduction in trade deficits and rise in export earnings.

Despite the odds, better export performance by gold and mineral water subsectors, and, soaring tourist arrivals establishing a new record in 2010 in response to competitive pricing and discounts offered by the hotel industry, as well as remittance inflows, enhanced the credibility of the country and established that it can still survive and thrive! The data on external debt available until 2008 shows that Fiji’s external debt was low at 11.1% of its national output and debt servicing is less than one percent of its export earnings. These low ratios have also contributed to the positive image of Fiji in the eyes of overseas investors.

Opportunities

The new bond issue, which would bring in US$250 million, would add to the resources of the country.

As we all know, if the same equivalent amount in Fiji dollars (F$500 million) were to be raised by domestic borrowing for financing budget deficits and infrastructure investments, it would only be a transfer from private sector
to public sector. On the other hand, external borrowing is not only a net addition to total availability of resources but also an addition to the country’s external reserves.

The country’s exchange rate will no longer be under pressure as it was in the months prior to the devaluation of the currency in April 2009.

If the currency appreciates in value, it also helps the country to keep inflationary pressures under control, as most of the inflation is due to exchange rate pass through. Further, in a fixed exchange rate regime, rise in foreign assets leads to automatic rise in money supply, unless sterilised. That leads to a fall in interest rate. Other things remaining the same, it would encourage investment. In any case, private investment would not be discouraged. In fact, a growing level of confidence in the economy would kick up the “animal spirits” among the investors and consumers of durable goods. Rise in investment would no doubt lead to imports of capital and intermediate goods.

However, additional imports can be comfortably met by increased foreign exchange, now helped by the second bond issue of US$250 million. Opportunities give rise to challenges as well.

**Challenges**

The highly reputed international Journal of Policy Modelling in its recent issue, meant primarily for policy makers, carried an article on “External Debt and Growth in Pacific Island countries”. The study stresses the need for caution in the utilisation of external loan proceeds.

Prudent utilisation means valuable foreign exchange has to be spent only on growth enhancing sectors of the economy, especially in the export sectors. The externally raised loan has to be eventually paid back in foreign currency. Better performance by foreign exchange earning sectors lowers the opportunity cost of transfer of resources involved in debt servicing and repayment of loan proceeds.

Public sector reforms and re-vamping or privatisation of government
undertakings and closure of non-performing enterprises now assume greater importance than ever before. The prime need is to cut the ratio of recurring expenditure to capital expenditure. It is now in the range of 70 to 30. It should be cut to 40 to 60. The ministries and agencies have to be reduced to a reasonable number. Junkets for civil servants have to be reduced to zero. Overseas trips, unless funded by international agencies or bilateral partners, should not be undertaken. There should be a freeze on civil service wages and salaries.

If Fiji had taken a loan from International Monetary Fund (IMF), these very reforms would have been imposed through conditionalities. All standby loans or structural adjustment loans from IMF and other agencies, which are funded by tax payers in advanced countries, carry these harsh conditionalities.

**That is their job**

Presently, Ireland, Greece and other troubled member countries of the rich nations ‘club’, Eurozone, are going through it. Remember the placard carried by the protestors in Dublin streets: Imposed Misery Forever (IMF).

Fiji has successfully avoided these conditionalities by not resorting to IMF’s Standby arrangement.

So, the country has to implement the reforms on its own. Just as charity begins at home, austerity too begins at home. The successful second bond issue has opened up a vista of opportunities: bright future! That should not lull the nation into inaction.

If the decision makers implement the needed reforms, this new debt would end all future debts!
In Fiji, it is budget time again.

The concerns would centre around fiscal deficits, external current account deficits and of course, the public debt.

Over the past two weeks, we’ve discussed current account deficits and budget deficits. So, we appropriately focus this week on public debt.

Interestingly, the Australian Treasurer, Mr. Joe Hockey, has also initiated a debate on the subject, announcing that there is a need to raise the country’s debt limit by 67 percent. The current limit, which is AUS$300 billion, was set by Parliament in June 2012 when the Labour Party was in power.

The new coalition government, which replaced the Labour government this year, wants to raise it to AUS$500 billion. The new bill will be considered by Parliament this month.

The ongoing Australian debate is, “Why this new ceiling of half a trillion dollars now?”

The arguments for raising the debt limit are two: (i) by mid December, the present limit of AUS$ 300 billion would be reached; and (ii) as the debt level is expected to go up to hit AUS$ 400 billion in the next four years, it is better to raise the ceiling now rather than later, when the government would have to face the next election.

A history of ceilings

The debt limit is a self imposed one. It is prevalent in four countries: Australia, Canada, Denmark and the US. The US has no constitutional requirement for a limit on government borrowing. However, the executive and the legislative wings agreed to have a ceiling in 1917. There were disputes, whenever government informed the US legislature of the need for increasing the debt limit. The October 2013 two-week shutdown of the US economy is an example.
It was agreed to re-examine the case in mid January 2014. In the meanwhile, the ceiling was increased from US$16.3 trillion by US$305 billion to US$16.7 trillion. The American debt is nearly 106 percent of GDP.

The Pacific region

The Solomon Islands has a debt limit since 2005 under the Honiara Club Agreement (HCA), signed by international lenders and the government. Under the HCA, assistance is being provided for rescuing the economy from a deep financial crisis. One of the HCA requirements is a Debt Management Strategy, which has set a limit at SI$150 million (2 percent of GDP). Further, the country cannot borrow from official external lenders until it received a “green light” rating from the World Bank’s International Development.

These restrictions have resulted in total debt (domestic and external) falling to 22 percent of GDP from 60 percent in 2005. Domestic debt is one third of total public debt. Total external debt has also declined to about 25 percent of GDP, from 50 percent of GDP in 2005.

Other major island countries, including Fiji, Samoa, Tonga and Vanuatu have not faced debt crises of the kind which hit Solomon Islands.

As Samoa, Tonga and Vanuatu’s domestic financial sectors are small, domestic borrowing is small. Its external debt is large. All of them are eligible for concessional loan assistance from international lenders at low interest rates. Thus, the debt servicing costs in foreign exchange are low as well.

Samoa’s domestic debt is less than 4 percent of GDP. Its external debt was 48 percent of GDP). Since its external debt was mostly from international lenders with a high grant element, Samoa has no major debt problem.

Vanuatu’s total debt is 21.6 percent of GDP. It is dominated by external debt, which is 13.9 percent. Since Vanuatu’s external debt is mostly concessional loans, debt service costs are low.
The only country with a potential debt crisis is Tonga. Its debt is 43 percent of GDP, dominated by external debt (39 percent of GDP). The March 2013 IMF Article IV Consultation Mission issued a warning that “high external indebtedness remains an important vulnerability since grace periods on the external loans, mostly from China, are expiring in 2013/14”.

China extended the grace period of a loan of US$60 million, days before its first payment of nearly US$ 7 million was due in late September. It is not known how long this extension of grace period would be. There are other loans due for servicing in 2014.

Tonga’s external debt is dominated by loans from China, creating yet another problem of an excessive exposure to a single foreign currency.

**Fiji’s 2014 Budget**

It is the most expansionary budget of all. It has a huge lot of “giveaways”. Yet, it has projected a very small deficit of 1.9 percent of GDP. Because of a low budget deficit, there is no problem on the debt front.

Total debt which was estimated at 49.3 percent of GDP for 2013, is expected to decline to 48.3 percent of GDP in 2014.

A conscious effort towards reducing budget deficits is always welcome. Additionally, if external debt stock is reduced and if international reserves (September 2013 reserves: FJ$ 1.8 billion) are increasing each year, debt servicing which is often in foreign currencies, would not pose any problem.

Current account deficits are sustainable, with steadily rising remittances and tourism earnings. If the tax collection machinery works, tax revenues will be buoyant as well. Domestic debt servicing costs will also be declining over time, reducing both primary and net deficits.

So, the answer to the question is, we do not need a debt ceiling, unless the trends are in the opposite direction.
There were two reports on Fiji’s economic health in April 2013: one by the Reserve Bank of Fiji, the other by the Asian Development Bank.

The RBF report is part of a monthly series of economic reviews on Fiji. The report by ADB is part of its annual development outlook study for its developing member countries from Asia and the Pacific, issued in April each year, and followed by an update six months later in October.

The RBF’s economic review for March 2013 notes weak performances in the foreign exchange earning export sector. The declines were in sugar, timber and gold. While gold production declined by close to 20 percent due to lower quality grade ore, tourism was hit by the impact of Cyclone Evan of late 2012.

Positive trends

However, there were some positive trends. These included increases in domestic consumption, as reflected in a 8.8 percent rise in total VAT collections in 2012. The domestic consumption was supported by inward remittances which grew by 5.3 percent and by a rise in domestic credit for consumption purposes by $109.9 million.

In addition to the rise in domestic consumption, there was notable growth in investment activities which were reflected in increases in cement sales by 85 percent and post-cyclone Evan rehabilitation and other construction activities. Fresh bank credit for building and construction activities also rose. The total bank lending for consumption and investment went up by 86 percent during the past one year period.

The monetary policy stance has been since October 2011 on an expansionary path, with the overnight policy rate (OPR) at the historically low rate of 0.5 percent. Added to this, moral suasion measures and the entry of a new bank have brought down the outstanding and lending rates. The outstanding lending rate fell to 6.36 percent in February 2013 from 7.17 percent in March 2012, while the new lending rate decreased to 5.90 percent. The decline in foreign exchange earnings was accompanied by a rise in
the import of mineral fuels and decrease in imports of food and beverages, machinery and transport equipment and raw materials. Foreign reserves are, however, still at a healthy level: F$1494.8 million, sufficient to cover 4.3 months of imports.

**Prospects in 2013**

The ADB development outlook for Fiji 2013 is an assessment of prospects on the basis of perceived trends.

Focusing on public finances, ADB notes Fiji’s net budget deficit in 2012 was estimated to be equivalent to 1.6 percent of GDP, larger than the 2011 figure of 1.4 percent of GDP. As budget deficits and current account deficits in external accounts are connected, the ADB report expresses some concerns. Current account deficit is the difference between outgoings and incomings in the external accounts. Higher trade deficit, which is a component of current account deficit, is due to lower sugar and gold export earnings. For 2012, exports grew by only 5.1 percent, far short of the forecast of 12.3 percent, whereas import growth estimates were revised upward to 5.4 percent from 4.7 percent.

**Impact on public finances**

It is anticipated that public capital expenditure would increase in 2013. It is expected to be 32 percent of total spending as against 29 percent in 2012. Most of it will be on new transport infrastructure ($225 million) and infrastructure rehabilitation. Further, the investment-to-GDP ratio is likely to exceed 25 percent of GDP. Added to an increase in investment, there is an expected rise in consumption expenditure consequent to an increase in household disposable income resulting from lower personal income tax rates, and the implementation of a 10% wage increase for public employees earning below F$10,000 per annum. With these expected increases in total aggregate demand, the ADB report says the current account deficit might widen.

Furthermore, the addition of three new Airbus 330 planes and the likely
deterioration in the ratio of prices of exports to prices of imports of Fiji, known as terms of trade, would result in widening the current account deficit to around 22 percent in 2013.

While the budget deficit would be funded by domestic borrowing, the current account deficit would be funded by loans from the export–import banks of China and Malaysia. This is likely to result in an addition to the current stock of public debt, which is estimated at 50.4 percent of GDP. About three-fourths of public debt is held in the form of government bonds purchased by FNPF. External debt stock would also increase.

In these circumstances, the policy implications are clear. They are also familiar.

The ADB report lays stress on a better investment climate and business regulatory environment; removal of all barriers to higher growth; improvements to fiscal flexibility; and implementation of structural reforms, particularly in the sugar sector.
Last week’s visit to Fiji by Australia’s foreign minister, Ms. Bishop, has raised hopes of a return to normalcy in bilateral relations between the two countries.

The visit has been fruitful in many ways: Fiji has been added to the list of Pacific island countries (PICs), which are eligible for Australia’s Pacific Seasonal Workers Program. This program confers the benefit of guest worker visas for fruit picking jobs in Australian farms.

Other results include the resumption of programs including (i) exchange of civil servants in finance and foreign policy departments; (ii) joint military exercises and training; and (iii) participation in a sea patrol boat programme.

The discussions might have included resumption of overseas development assistance (ODA) or foreign aid.

Just a day prior to Fiji visit, Ms Bishop inaugurated the 2014 Australasian Aid and International Development Policy Workshop in Canberra. The Workshop assembled researchers from across Australia, the Pacific and Asia for discussing the future directions of Australia’s foreign aid.

**Role of aid**

Foreign aid is not mercy.

It is not unselfish manna from heaven.

In Shakespeare’s *Merchant of Venice*, Portia describes mercy thus:

“The quality of mercy is not strain’d,
It droppeth as the gentle rain from heaven
Upon the place beneath. It is twice blest:
It blesseth him that gives and him that takes”.

Aid is not altruistic.
In her inaugural speech on Feb 12, Ms. Bishop was clear: “Aid is a powerful tool in our statecraft. It is ultimately designed to protect and project Australia’s broader interests”.

It is understandable. Aid is taxpayers’ money.

It should promote the country’s external objectives.

Before the fall of the Berlin Wall in 1989, foreign aid from the West had a single objective: “contain the spread and reduce the influence of the Soviet Union”.

Since the 1990s, the focus has changed.

In the case of PICs, the donors shifted from providing budgetary support to PICs. It is now for funding projects and programs, which add to income generating activities for poverty reduction and for institution building capacities.

In more recent years, the emphasis is on good governance and efficiency in delivery of services.

Foreign aid adds to domestic savings. Being in foreign exchange, it adds to real resources of PICs. Aid also helps to bridge the deficit in PICs’ external accounts and stabilise the exchange rate.

**Fiji and foreign aid**

Amongst PICs, Fiji receives the least foreign aid from donors, including Australia. In recent years, on average, Fiji received annual foreign aid to the extent of 2 percent of the country’s gross domestic product (GDP) as compared to the corresponding ratios of Samoa (35 percent), Solomon Islands (60 percent), Tonga (34 percent) and Vanuatu (25 percent).

The degree of aid dependency is much less in the case of Fiji.

In recent years, annual remittances from overseas residents because of globalisation and increased migration of workers and professionals, has dwarfed the importance of foreign aid to Fiji.

Aid effectiveness

In a severe indictment, Professor Helen Hughes noted poor economic growth in the midst of plentiful supply of aid by the West and observed that foreign aid had failed PICs. She exposed weaknesses in aid administration: poor project selection; ineffective implementation; slackness in monitoring progress; and inadequate evaluation. She was also critical of how government leaders in PICs played one donor against another and tried to grab more aid for personal benefit.

Australia had to review aid policies. In the meanwhile, the war against terrorism began soon after the 9/11 event of 2001, which brought on special responsibilities for Australia, as the “Deputy Sheriff” for the Pacific.

Roger Riddle in his keynote address to the Workshop said the question three decades ago was whether projects funded met their objectives in terms of schools built and roads paved; and more recently whether aid projects made any dent on poverty.

Today, the question before us is whether poor countries would have been better off without the aid they received.

Free money has perpetuated poverty. It deepened the dependency syndrome. Growing evidence shows aid money has killed exports of traditional crops. Domestically processed goods are now less competitive overseas. By encouraging consumption of traded and non-traded goods and services, aid has contributed to the appreciation of PICs’ currencies and made exports less attractive, known as Dutch disease.
Aid is no longer twice-blessed.

PICs now say: “No aid! Let us trade and earn foreign exchange in an honourable way; encourage migration and workers will boost remittances back home.”

The Bard of Avon would have added another verse in his Hamlet:

“Neither a donor nor a receiver be,
For aid loses both itself and friend,
And free money dulls the edge of husbandry.”
For the past four decades, Pacific island countries (PICs) have been well known for their aid dependency syndrome, a continuing malaise ever since their independence in the 1970s. Generous aid money received from donors, who were the former colonial rulers, was initially for annual budgetary support. Aid, known as official development assistance in terms of pure grants, was for salaries to civil servants and other recurrent expenditures.

The objective behind aid was to provide resources for the critically needed growth enhancing physical infrastructural facilities as well as investment in social infrastructure including health and education, as governments of PICs were not raising adequate revenue from taxes and user fees.

A Paradox

During 1970-1990, Samoa, Solomon Islands, Tonga and Vanuatu received aid in the range of 35 to 45 percent of their gross domestic product (GDP). Fiji was an exception. It was rarely more than 4 percent. It averaged around 2 percent of GDP.

While the Caribbean and Indian Ocean island nations which received much less aid did well, PICs were faring poorly. The growth rate in the Pacific was barely exceeding one percent. Per capita incomes in real terms were stagnant. That provoked the World Bank in their first ever series of economic reports on PICs published in 1993, to refer to the phenomenon of poor growth in the midst of plentiful aid as the “Pacific Paradox”.

A more famous paradox was immortalised by Samuel Taylor Coleridge in the Rime of the Ancient Mariner. It is the story of a sailor’s long sea voyage with near death experiences:

“Water, water, everywhere,
And all the boards did shrink;
Water, water, everywhere,
Nor any drop to drink.”

That was the result of the curse associated with the killing of the Albatross by the sailor.
End of Cold War

Following the fall of the Berlin Wall in 1989 and demise of the Soviet Union, the West’s attention was turned on rebuilding Eastern Europe. Cutting down of annual aid flows to PICs began with a review of aid to PICs by Development Assistance Committee (DAC) of the Paris-based think tank of the Organization of Economic Cooperation and Development (OECD) in 1991. Britain was the first to phase out of bilateral budgetary support to PICs.

Another consequence was the redirection of aid flows, focusing only on projects and programmes such as health and education, and for institution building and policy reforms. Further, donors began to co-ordinate with each other and international lending agencies for ensuring there is no duplication of project or programme aid.

The purpose behind these actions is to conserve shrinking aid resources and maximise returns to donors. Here comes the subject of the boomerang nature of bilateral aid. Every donor government is concerned about tax payers’ reactions. It is keen that free aid given out results in generating jobs for its own citizens by way of consulting services and increase in exports of capital goods.

Continuing curse of aid

The latest study on aid and growth in the Pacific is more alarming.

Alfred Deakin Research Institute’s study led by Professor Mark McGillivray with Sustineo Pty Ltd as the industry partner evaluates the effectiveness of aid given out by 27 major countries. It notes that progress towards the UN Millennium Development Goal of halving income poverty is the worst of all regions in the world.

Observing that the Pacific is a tale of paradise almost lost, McGillivray says: “Pacific Islands have consistently recorded the lowest and most volatile rates of per capita economic growth of any region in the world.” The finding is no different from that of the World Bank’s 1993 study.
The contribution of McGillivray and associates is the development of an index ranking the 27 major donors on aid, trade, migration, finance, security, the creation and dissemination of new technologies and the promotion of environmental sustainability. China is not included because of incomplete information.

The top five donors to PICs are: New Zealand (1), Australia (2), Denmark (3), Finland (4) and Portugal (5). UK is ranked at 8, France at 10, and USA at 18. The lowest ranked is Korea, and Japan is slightly ahead at 25.

The study concludes aid alone is not enough to address the development challenges that the region faces. It is apparent that reforms, structural and policy oriented, are needed and that too in many areas.

Encouraging greater mobility of islanders seeking employment in advanced countries resulting in greater remittances to PICs, is one of the solutions.

The study ranks New Zealand as the best performer in this area as well.
Which is better for financing the budget: foreign aid or debt?

That is always the question before Pacific island countries (PICs) each year. The dilemma becomes acute when the future is uncertain with mounting public debts and rising debt servicing obligations.

Tonga’s Finance Minster chose aid as a better alternative for financing the country’s 2014-2015 budget. It is also Tonga’s biggest budget in the country’s history. The total budget, with growth enhancing capital investments, cost 483.7 million Pa’anga (US$257.7 million).

**Role of aid**

About 59 percent of the budget (US$152 million) is funded by aid and 41 percent (US$105.7 million) funded domestically.

While presenting the budget, the Finance Minister referred to the implications of Tonga’s rising debt: total debt 43.5 percent of GDP, dominated by external debt (40 percent).

Although China postponed the repayment of the loan (US$119 million) for another ten years, borrowed for reconstruction after the 2006 riots that affected Nuku’alofa, annual debt servicing obligations remain. About 50 million pa’anga (US$ 27 million) has to be annually mobilised.

The China loan was on-lent to owners of properties in Nuku’alofa destroyed by the 2006 riots. Some beneficiaries have not executed on-lending agreements with government. Some who signed the agreements and started deriving rental incomes from renovated properties have yet to begin paying their dues.

An IMF and World Bank Debt Sustainability study has changed Tonga’s rating from high to moderate risk of debt distress due to the improvement of the Country Policy and Institutional Assessment rating from ‘Weak’ to ‘Medium’. However, it advises a cautious approach towards new non-concessional loans by referring to repayments on loans from the China EXIM Bank. The study also warns of a rise in debt service burden and
currency risk. About 60 percent of external debt is in one currency, the Chinese.

A prudent blend

Tonga prefers the blend: 59 percent by aid and 41 percent by domestic resources. It is indeed a prudent approach to debt management considering the fact that debt service ratio (ratio of servicing obligations in foreign exchange as a percent of Tonga’s export earnings) is also on the rise, close to 8 percent.

The blend of development assistance (loans and grants) adopted by Asian Development Bank (ADB) in regard to highly indebted nations is relevant here. External debt of Marshall Islands, with revenue of only US$107 million is high: US$120 million (over 70 percent of GDP). It has 13 loans owed to ADB amounting to US$73 million, and, US$50 million to US. Last month, ADB decided that Marshall Islands should be assisted only with grants: no more new loans.

Some concerns

While expressing his concern over the reliance of Tonga on foreign aid for the budget, Dr. Sitiveni Halapua, a Tongatapu People’s Representative, compared it to “building a family home with donor’s fund so that at the end, one would feel that the donor owned the home”.

Is Dr. Halapua correct?

Aid always has played an important role in the history of growth and development of PICs. Before the 1990s, the bilateral aid was for both recurrent and capital parts of the budgets. The shift in emphasis came in the 1990s soon after the end of the Cold War. Traditional donors discontinued supporting recurrent expenditure and started assisting only capital projects.

Donors know PICs are highly dependent on food and fuel imports with a
limited range of their exports to pay for imports. They are aware PICs need to be assisted with aid and other means of generating valuable foreign exchange for investment in physical and social infrastructure. Innovative measures to improve remittances and non-debt creating capital inflows, including seasonal labour mobility schemes, along with aid for trade, are in place.

Rising capital inflows are part of globalisation. The commitment that developed countries made 35 years ago to set apart a minimum 0.7 percent of their national outputs as official development assistance, still holds good.

Less aid inflows do not make any nation more independent or more sovereign. What is advised against is dependence on or debt exposure to a single country.

In Tonga’s case, sources of aid are well diversified. They range from Australia, EU, Japan and New Zealand to UNDP and WHO. Therefore, Dr Halapua’s comparison: Tonga’s budget to “building a family home with donor’s fund so that at the end, one would feel that the donor owned the home”, is not correct. As an economist, he knows what makes sense for a household may not make sense for a nation.

He spoke as a politician sitting in the opposition.
Earlier, we discussed Samoa’s exchange controls. Fears of falling foreign exchange reserves and rising external debt prompted these stringent steps.

This week, our focus is on Vanuatu.

The picture is in sharp contrast to what we saw last week.

**Praise from IMF**

At the end of a week-long mission to the country, the International Monetary Fund (IMF) in a public announcement on March 4 commended Vanuatu’s efforts towards stable economic growth. Specifically, IMF referred to the country’s record of a low public debt and substantial international reserves.

The IMF undertakes in the case of its member countries in the region, except Fiji and Papua New Guinea, biennial consultative missions to review in a very comprehensive manner their economic health under Article IV of its Charter. In the case of Fiji and PNG, which are major PICs, the Article IV consultation missions are normally annual.

The last Article IV mission to Vanuatu was in June 2013.

The latest 24 February 24- 3 March 2014 mission is part of follow up missions. Its purpose was to discuss the economic outlook and policies with the government, private sector and development partners.

**The Progress**

The IMF notes impressive pickup in economic activities in Vanuatu. The economy has recorded a notable growth rate of 3 percent in 2013, with several donor-funded infrastructure projects under construction.

Inflation for 2014 is expected to be within the target range of 1 percent to 4 percent.
Further, Vanuatu’s foreign exchange reserves are at a comfortable level of around 7 months import equivalent, much higher than those of Fiji and Samoa. Further, the debt level at the end of 2013 is low: 22 percent of gross domestic product (GDP), domestic debt being 9 percent and external debt 13 percent.

These favourable developments are tempting the country to launch an ambitious phase of economic programmes. This includes loan-funded infrastructure projects.

**The concerns**

The IMF has concerns with ambitious projects which are likely to be funded with borrowed funds. Although Vanuatu, being a low middle income country is eligible for concessional borrowing from international funding agencies such as Asian Development Bank, servicing them does involve foreign exchange.

The IMF advised the government to undertake careful project analysis and sound evaluation of returns before deciding upon committing their limited capacity to project implementation.

Implementation capacity determines returns on each project. They have an impact on future debt. Even concessional loans would result in a heavy debt service burden, if returns are disappointing.

Any rash decision in the light of the current favourable conditions would land the economy in difficulties. The IMF mission highlighted the need for taking into account the implementation capacity before deciding the scale and sequencing of the public investment programmes.

Vanuatu has been following prudent budgetary policies. Thanks to strict public expenditure control measures in place, the country is on track to deliver a budget surplus for 2013.

With the damage inflicted on the Vanuatu economy by Cyclone Lusi, the authorities are well aware of the need for retaining the policy space to
maintain confidence and as a cushion against recurring shocks.

**Lessons for island nations**

Vanuatu has been a consistent, top performer in the region.

By pursuing sound budgetary policies since the early 2000s, it accumulated enough fiscal space. That stood in good stead to mitigate the adverse consequences during bad times, which followed the world economic downturn since 2009.

By running budget surpluses in good years, it also avoided domestic borrowing in bad years. Its debt has been only from international lending agencies. The loans were on concessional terms.

Supported by tourism earnings all along because of its high reputation as an open economy with no exchange controls and no personal income taxes, and along with remittance inflows ever since the Australian Seasonal Work Program began three years ago, Vanuatu was able to build a sizable foreign exchange.

With limited commodity export earnings unlike the more fortunate Papua New Guinea and Solomon Islands, Vanuatu emerged unscathed in recent years, despite unpredictable natural disasters.

Its low public debt record (22 percent of GDP), against Samoa’s 65 percent of GDP, and Fiji’s and Tonga’s 50 percent, is the envy of all.

The IMF advice to Vanuatu, in the context of its ambitious borrowing plans to fund new infrastructure projects, holds good for all: Screen the planned projects with an eye on their returns and remember the implementation capacity restraints, as every external loan, concessional or otherwise, has to be serviced.

“The challenge before authorities is to support growth while protecting its policy buffers.”
As usual, there were several 2013 Budget submissions made in Fiji over several weeks.

One of the submissions was that government should raise the value of the Fiji dollar by 5 percent to 10 percent to reduce inflation. It was argued that both businesses and consumers rely more on imported products, from manufacturing to retailing, and more expenditure is incurred by business and consumers. The submission stated that if the value of the domestic currency is increased, the imported items would cost less. It was also claimed that relief in terms of lower import costs would be welcomed by consumers and manufacturers alike.

The 2009 devaluation

A foreign exchange crisis led to devaluation in 2009, when there was a rapid decline in foreign reserves by the end of 2008. They amounted to about F$560 million, sufficient for two months of imports. The decision was taken on April 15, 2009 to devalue the Fiji dollar by 20 percent. The Fijian dollar was US$ 0.57 before devaluation. After devaluation, it was US$0.45, the drop being 12 cents.

Consequent to devaluation, a rise in earnings from commodity exports and services including tourism, led to growth in foreign reserves in the next three years. By end of October 2012, foreign reserve levels had risen to F$1,581.6 million, sufficient to cover five months of imports at current prices.

No doubt landed prices of imported goods of all sorts, food, fuel and raw materials and capital goods went up as a result of devaluation, whether or not the imported materials were imported before devaluation.

In the 12 months following the April 2009 devaluation of the currency, inflation was over 10 percent. However, it moderated to 4 percent by end of 2010.
During the 12 months ending Sept 2011, the consumer price index rose only 3.7 percent.

**Purpose of devaluation**

Devaluation is an adjustment measure to correct balance of payments disequilibrium. The disequilibrium is reflected in widening trade deficits and current account imbalances.

In a country under a fixed exchange rate regime, as in Fiji, an adequate level of foreign reserves is needed to defend the fixed exchange rate. Only under a flexible exchange rate system is there no need to maintain reserves.

Fiji cannot afford to have a flexible exchange rate system. Fiji’s exports earnings are determined by a very limited range of exports including sugar, tropical fruits and vegetables, tourism and remittances. Further, the export earnings are seasonal and are not steady throughout the year. On the other hand, imports into Fiji are not only steady but they exceed exports in certain times of the year.

In such circumstances, a floating regime would play havoc. High volatility in the exchange rate would affect investment decisions. A fixed exchange rate regime has served the country well but a steady exchange rate requires adequate level of reserves.

The devaluation of April 2009 was resorted to in order to correct the fundamental disequilibrium. A high trade deficit (31 percent of national output) and current account deficit (18 percent) necessitated a drastic remedy. If the country had borrowed funds for structural adjustment to improve balance of payments from IMF, austerity measures would have to be implemented as part of conditionalities.

**Uncertain world economy**

The US economy has been in the doldrums since 2008. The euro crisis is continuing. Only mineral exporting economies including Australia did well. Bilateral exchange rates react in a predictable fashion and so the Fiji dollar
declined against the Aussie dollar and appreciated against the US dollar.

In these uncertain circumstances, the competitiveness of Fiji’s exports is of paramount concern. One measure is the real exchange rate (RER), which is the product of nominal exchange rate and ratio of the domestic price level to world price level. Given the nominal rate, a rise in domestic price level relative to the world price level would result in an increase in RER. Increase in RER would hurt the competitiveness of exports and tourism. Fiji needs to protect its level of resources in an uncertain world. A 2012 IMF study showed the Fiji dollar is broadly in line with fundamentals with no deviation of any significant concern.

With a benign world inflation outlook, there is no need to effect any change in the nominal exchange rate.
Promoting economic growth through trade does not have to be only through protective tariffs on imports or quota restrictions.

In these days of free trade rhetoric, a country can manipulate its exchange rate and achieve the same objective of promoting exports and discouraging imports, thereby improving the trade balance.

Not every country can afford to play a currency manipulation game. Only giant economies can do that!

China’s trade with the world, which has been in consumer goods of all kinds, has been successful because of its low wages. Opening the country to the world, through initiatives launched by communist theoretician Deng Xiaoping thirty years ago, has paid rich dividends.

**China’s trade surplus**

China built huge trade surpluses over a 15-year period. Trade surplus is defined as the difference between exports and imports of goods and services. China’s foreign reserves stand at US $1.5 trillion.

America, known for its legendary appetite for consumer goods sold through its nationwide Wal-Mart outlets, contributed to China’s trade success over the period.

Aside from low manufacturing costs, a deliberately kept low exchange rate did the trick. The Chinese renminbi, which was pegged at 8.28 renminbi per US dollar in 1997, remained unchanged for eight years until 2005. Trade surplus rose to US$ 200 billion in 2005 from US$ 50 billion in 1997.

As the US trade deficits increased, annual budget deficits also grew in size ever since the two wars in which USA is involved began in 2001, compounding the situation.
Instead of the usual remedies dished out to other nations including tightening the belt through fiscal discipline, America chose the easier option: it wanted China to re-value its currency upwards and make their exports to US more expensive and unattractive!

Since the Republican Administration is committed to free trade, imposition of tariffs and quotas was out of the question.

As trade surplus and inflows of foreign direct investment grew, the Chinese currency gained in strength. Its pegged exchange rate was not, therefore, in alignment with the natural rate. After considerable plodding by US, China allowed its exchange rate climb up to 6.8 renminbi per US$ in 2005.

China was aware of the benefits of aligning the exchange rate in accordance with fundamentals. Fighting inflationary pressures due to capital inflows was facilitated by appreciation of its exchange rate.

**US financial meltdown**

Recessionary conditions triggered by the financial meltdown in the US since early 2008 worsened economic prospects.

It was obvious that China would not be able to keep up its red hot growth rate of 12 percent per annum. A decade-long, export driven growth track cannot be maintained in the coming years when the industrialised countries are predicted to be slowing down. Exports of China predictably fell.

It was a clear impact of job losses in the Western world, especially in the US, and falling incomes with poor consumer confidence during the Christmas holiday season and following months ahead.

Thousands of factories in the export regions of China manufacturing labour intensive goods such as shoes, clothes and toys closed. Added to the closure of cheap export factories, social unrest spread. There was news of riots in southern China with violent strikes and protests.
Options before China

China like other countries reduced its interest rate. It also announced a fiscal stimulus package of huge proportions. In addition to the infrastructure programme by provincial governments to the tune of US$1.4 trillion, the central government would be implementing its own, another US$600 billion on development works. But still the export prospects did not look bright. The currencies of Asian countries have also weakened against the Chinese currency, hurting Chinese exports to the rest of Asia.

One option is clear. Against the appreciation of the renminbi with respect to Asian currencies, it is to the advantage of China to allow its currency to weaken against the US dollar. The Chinese President hinted at the possibility of resorting to depreciation. That rattled the American treasury.

Having successfully persuaded China to up–value its currency all these years, any reversal of the trend would only hurt US prospects of growth in the current period of uncertainties. So, during his visit to China, the US Treasury Secretary had to change his tune. He pleaded to his Chinese counterpart not to depreciate the currency, a tune so different from his earlier visits, when he used to plead for appreciation of the renminbi.

Limitations to depreciation as a remedy

If markets expect renminbi depreciation, there would be capital outflows from China. That would only complicate the easy monetary policy change made by the Chinese central bank to help the economy recover. Capital outflows would result in an increase in the domestic interest rate: a classic case of the dilemma. One cannot achieve monetary independence without sacrificing one of the other two objectives: capital mobility and exchange rate independence.

Any exchange rate depreciation for promoting exports to the US would strengthen President Obama’s resolve. During his campaign, Obama indicated that he would press China to re-value its currency.
Furthermore, depreciation of Chinese currency would harden the protectionist sentiments in America.

Above all, it is feared that Chinese currency depreciation would lead to competitive devaluations in Asia, similar to the ones witnessed during the 1997 financial crisis. Such competitive devaluations would only worsen the global instability in exchange markets.

China faced a tight situation as it observed the 30th anniversary of the reform initiatives launched by the modern day communist guru, Deng Xiaoping, on 18 December.

However, for saving communist China’s success through capitalist moves in the 21st century, there will be no ideological qualms.

As the guru observed, “The color of the cat does not matter, so long it catches mice!”
Three events in March 2011 rekindled public interest in the long pending policy reforms facing Fiji’s economy.

First, on March 9, there was a launch of the February issue of the Pacific Economic Monitor (PEM).

This tri-annual publication by the Asian Development Bank is devoted to a review of latest economic trends in Pacific island countries including Fiji, with a set of policy reforms for consideration by decision-makers in the region.

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

**Conditionalities**

More importantly, the bond issue helped Fiji avoid the conditionalities, which are attached to the credit facility, known as the Standby Arrangement (SBA) from the 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 protesters in Dublin described “Imposed Misery Forever” (IMF).
In June 2010, Fiji was exploring the possibilities of seeking assistance from IMF of no less than FJ$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.

**IMF 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’s 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 the sugar industry and reducing public debt from the present level of 59 per cent of gross domestic product to a more sustainable level.

**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 the IMF, an appropriate first step would be to move to an exchange rate band of 2 per cent to 3 per cent around the current rate.

The recommendation is apparently based on IMF’s evaluation of the size, timing and impact of the April 15, 2009 devaluation of the Fiji dollar on the economy.

The devaluation was by 20 per cent; from US$0.57 (FJ$1.04) on April 14, 2009 to US$0.45 (FJ$0.82) on April 15, 2009.
Economists refer to the measure as an expenditure switching effort, as devaluation makes imports more expensive and consumers 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 that Fiji is heavily dependent on imports, from food and fuel to manufactured goods, and its range of exports is narrow and small. Foreigner’s 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 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, the domestic price level went up as Fiji’s demand for imports is highly price inelastic. The result is a high degree of exchange rate passed through.

The April 2009 devaluation was justified on the grounds that it was long overdue. There was a deviation from the fundamentals for a long period and it needed correction. Pressures on the 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 discussion on the 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, a fixed exchange rate regime is advisable.

The IMF has acknowledged the role of a 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 are rapidly deteriorating.

Would not a 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 per cent to 3 per cent 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 per cent) and Tonga (5 per cent).

The recommendation is worth considering.
To devalue or not to devalue.

That is the question which confronts countries once in a while, if their currencies are under fixed exchange rate regimes.

Two countries are now facing the painful choice. One is Greece, a member of the 17-member Eurozone. The other is Samoa in our region.

**Grexit**

Greece’s problem is more severe. It is similar to the unpleasant choice faced by legendary Greek hero Odysseus and his men, who had to pass through a strait where they were caught between sea monster Scylla and the whirlpool made by Charybdis.

Greece has to decide: “To be in or not to be in?” If not in, the answer is easy. It has to go back to its previous currency and it will have to be devalued. Greece exiting the Eurozone, nicknamed Grexit, became a real possibility.

The Government debt of Greece in 2011 was 165% of gross domestic product (GDP), more than double the Eurozone limit of 60%. Its budget deficit in 2011 was 13%, more than 4 times the allowed. Since fiscal tightening, involving cutting public and private spending aimed at slimming down to emerge stronger in the next five to seven years is not feasible, the “ship-out” solution is politically more acceptable than the painful “shape-up” remedy.

Returning to the drachmas of the previous currency, the “prodigal son” will see a “fatted euro” rather than a “fatted calf” ready. The euro would cost more in terms of drachmas. It would be 1000 to 1500 drachmas as against 340 drachmas in 2001, when Greece euro joined the club. Thus, devaluation would be by 200% or more.

The consequences could be summed up in one word: catastrophic. Aside from inflation, external debt, when re-valued in drachmas, will rise in absolute terms as well as a percentage of national output; private debtors owing moneys to banks outside Greece will have to set apart a higher proportion
of their incomes for servicing debt. Foreign investment inflows will dry up. Unemployment will shoot up. The list of woes lengthens.

The other option is: stick to the euro and suffer the consequences of fiscal austerity.

**Turning to Samoa**

While the IMF Article IV Staff Report remained officially unreleased, it was unclear whether IMF wanted a devaluation of the tala. The IMF Public Information Notice said the “realignment of the exchange rate” is needed for two reasons: (i) for preventing further foreign exchange reserve losses; and (ii) for strengthening export competitiveness. “Re-aligning” is a euphemism for the invasive surgical procedure of devaluation.

Radio New Zealand International reported the reaction of the Governor of Samoa’s Central Bank that devaluing the currency is not the answer to the country’s poor export performance. So to go by the Governor’s word, we take it IMF wanted devaluation.

Should the tala be devalued?

The IMF says the tala has appreciated in real effective terms over the past decade and it must be hurting exports. Real exchange rate (RER) is determined by the actual nominal exchange rate (NER), units of foreign currency per unit of tala, and domestic price level relative to foreign price level. The RER is thus a product of actual NER and ratio of domestic price level to foreign price levels.

The nominal rate is influenced by net capital inflows. In Samoa, the major component of capital inflows is remittance inflows, which form 25% of GDP. Despite the recession, the ADB July issue of Pacific Monitor said there was a 10% growth in remittances during eight months of the fiscal year 2012 from Samoan migrants in New Zealand, United States, Australia and American Samoa.
A rise in RER would render exports less attractive. Given NER, the rise in domestic price level relative to foreign price level, RER rises; and if the relative price level remains the same, a rise in NER also leads to rise in RER.

There are advantages if NER rises. The stronger the tala, the cheaper would be the imports. With world food prices predicted to be rising due to shortages in the grain growing countries, government’s preference for a stronger tala is obvious.

According to the ADB, Samoa’s foreign reserves would cover five months of imports and is not unhealthy. The external debt has been brought down from 54% of GDP in 2009-10 to 49% in 2010 -11. The projections for the coming year’s show the debt would raise if budget deficits
Deep discontent with President Obama’s policies has strengthened conservative sentiments in America.

This week at the Republican National Convention (RNC) in Tampa, Florida, speeches were made criticising Obama’s unsuccessful fiscal policies, as four years added US$ 5 trillion (F$ 9 trillion) to national debt reaching US$ 16 trillion (F$ 28 trillion).

The Republican Party, which stands for less government, spending cuts and no rise in taxes, has officially nominated their candidates, Mitt Romney for President and Paul Ryan as Vice President.

**End of the Fed?**

Generally, politicians refrain from criticising the US Federal Reserve (the Fed), which is held high above politics.

However, ultra-conservatives do not spare the Fed. Amongst them is Ron Paul, an unsuccessful Republican aspirant for Presidential nomination. A medical doctor by profession, Dr. Ron Paul is an expert in monetary economics, since his entry into politics in 1997, as a Congressman.

In his *End of the Fed*, one of New York Times Best Sellers of 2009, Ron Paul advocated the abolition of the Fed. He argued that “In the post-meltdown world, it is irresponsible, ineffective, and ultimately useless to have a serious economic debate without considering and challenging the role of the Fed”. Paul accuses the Fed that by increasing money supply, it has debased the US dollar and fears it would lead to inflation. People will look to safe havens, including gold.

The RNC drafts of the party platform included an audit of Fed’s monetary policy and a commission to look at restoring the link between the dollar and gold.

Exactly 30 years ago, in 1981, President Reagan appointed a Gold Commission for restoring the gold standard. Only ten years earlier,
Republican President Nixon cut the link between gold and the dollar during the 1971 oil crisis. The Reagan-appointed commission rejected the return to a gold standard.

**Why the fascination with gold?**

The ultra-conservatives believe the Fed’s hands can be tied only if fixed amounts of gold were directly convertible to the U.S. dollar and vice versa and money supply can be limited by the amount of gold backing it.

The Republicans believe the ability to create fiat (paper money by decree) money out of thin air is a form of taxation and they oppose taxation. So a gold standard is logically appropriate, as it makes it hard for the Fed to print more money.

Steve Forbes, the free market guru, says the Fed was responsible for the housing bust, the commodities boom and the sovereign debt crisis in Europe because of its uncontrolled money creation ability during the last ten years. So, he argues one way for stabilising money is to have a gold backed dollar.

**Jealous Goddess**

Experts estimate the current monetary base of America is US$2.56 trillion (F$4.6 trillion) and the US has only 262 million ounces of gold. If the US returns to gold standard, bullion prices would rise as high as $10,000 (F$18,000) an ounce. That would destroy the dollar’s credibility as reserve currency and international trade balance would be in jeopardy.

The world’s official stock of gold is estimated at around 29,500 tonnes, or 17 percent of the world’s above-ground stocks. This compares to 19 percent held by private investors and nearly half of the stocks made into gold jewellery.

Return to gold would restrict money creation by the Fed. Strict rules of gold standard required trade imbalances between nations are settled in movements of gold, if countries prefer their “pound of flesh”.
Trade surplus brings in gold and adds to stock; and deficits reduce stock. Money supply will go up and will go down, as surplus and deficit happen and fluctuate with changes in gold stock.

The Fed has to sit and watch. It cannot have independent monetary policy.

Geoffrey Crowther wrote in his classic, *Money*: “Gold standard is a jealous goddess. She needs exclusive devotion.”

Opponents have a strong point: gold standard is deflationary, more often than not. No government in the modern world can afford to wait and see. Monetary policy has to be pro-active.

For increasing money supply, the Fed has to acquire more gold and the price of gold will soar. Only gold miners in South Africa and Canada will benefit.

The Republicans know the difficulties. Returning to the rejected idea after three decades is only a political ploy: to convince the electorate of their level of seriousness about the U.S. dollar, monetary policy and the budget deficit.

**The middle path**

Between the harsh reality and dreamy rhetoric, the middle path seems expedient.
Cut non-essentials and raise resources through taxing the ultra rich.

Maybe that is the Golden Mean?
The gold price had been falling over a week during April 2013.

Gold has traditionally been a safe haven for investors. People that feel their savings are not safe due to fears of expected inflation or political unrest or any kind of future uncertainties, turn to gold.

Gold has been an investment for all seasons.

During economic expansion, it is a hedge against inflation. When the world is hit by recession and share prices are going down, we turn to gold.

Over the decade 2002-2012, the price of gold was on the rise. It reached the highest at US$1900 in August 2012.

A steady decline began on Friday 12 April with a price below the US$1500 an ounce mark, the lowest since early 2011.

On Saturday 13 April, the gold price fell by US$87 to US$1,477 a troy ounce. The fall continued and on Monday 15 April, it was the steepest one-day decline in 30 years, a 9% fall and by US$140. The price tumbled to US$1,361 per ounce. Following the Boston bomb blast which shook the world, the price of gold went up on Tuesday to US$1,376. On Wednesday, the price was $1,373 an ounce in afternoon trading and on Thursday 18 April it was hovering around US$1,376.

It is predicted that the gold price will fall further to US1, 200 an ounce in the next five years.

Is it simply a correction?

Why the fall?

The world is still reeling under the effects of a recession that began in 2008. The IMF World Economic Outlook 2013 cut the forecast rate for 2013 from 3.5 percent to 3.3 percent, which is not different from the 2012 actual growth rate of 3.2 percent. The pace of world recovery is thus flat.
The latest report on US job numbers was disappointing. The Japanese recovery is wobbling through unprecedented quantitative easing. The yen fell heavily as the Bank of Japan pursued an expansionary monetary policy aimed at depreciating the currency with the hope of an export-led recovery. The Korean economy is shaken up by prospects of its own electronic exports decreasing in the light of the Japanese yen depreciation as well as from the fallout of tension over the North Korean threat. The euro crisis which seemed to have subsided with a bail out for Cyprus began to simmer again with a new crisis brewing in another member country: Slovenia. Furthermore, there was bad news that the Chinese economy was faltering.

With depressing news all around, why was gold not considered attractive anymore? Is there any other, better safe haven? Or as rumours floated around, was it the result of a conspiracy that China wants to buy more gold?

It is argued that it is not impossible for the banks to act as a consortium to get the gold price down so favoured countries can buy at lower price levels.

**Holders of Gold**

There are ten large holders of gold reserves. The governments and central banks know very well that in the world of paper money, which we hold in trust, gold is the ultimate store of value.

As of August 2011, it is reported that the largest holder of gold reserves in terms of tonnes as shown in the brackets is US (8,133); followed by Germany (3,413); IMF (3,217); Italy (2,452); France (2,450); Standard & Poor’s Deposit Receipts (1,121); China (1,054); Switzerland (1,040); Japan(765) and Netherlands (613 tonnes).

It is estimated that about 0.30 tonnes of gold are held by Fiji. The December 2012 balance sheet of Reserve Bank of Fiji showed gold holding of about F$2.5 million, which was less than 1 percent of total foreign assets of F$1,795 million. The latter include long term and short term deposits in foreign
currencies and various investments as well as IMF Special Drawing Rights of the country.

Returning to possible reasons for a fall in gold price, economists worked overtime to find out the reasons:

- Worldwide, inflationary fears are receding, despite massive quantitative easing (QE) in the US and Japan. The wholesale price index in the US was falling in March. So, people want to reduce their gold holdings

- Expectations that the QE by the US Federal reserve would end sooner than planned, as indicated in the minutes from last month’s U.S. Fed’s policy meeting; and therefore interest rates would rise

- Expectations that rising interest rates would strengthen the US dollar, which set off panic selling of gold and a shift to equities

- Likely rise in supply of gold as Cyprus was expected to sell its gold reserves to raise around 400 million euros to help finance a bailout.

- The other crisis ridden Eurozone countries such as Italy, Spain and Portugal might also sell their gold.

Gold is a commodity freely traded in the world market just as oil or food grains.

The fascination with gold is, however, on a different plane. It is beyond the cold logic of rationality. It is more subtle than the laws of economics.
The Aussie dollar is rising. The economy is doing well and so its currency!

If a person is doing well in his profession, business or studies, his credibility improves and status goes up. Credibility is a flexible concept, just as the floating currency. It wanes or waxes, depending upon the performance.

The opposite of the term “flexible” is fixed. The Fiji dollar is under a fixed exchange rate regime. The value of the Fiji dollar (US$0.5697) in terms of the United States dollar was re-fixed on 15 April 2009 when it was reduced by 20 percent to US$0.4558.

If one currency gets devalued, the other currency goes up in value, a seesaw effect. As a mirror-image reaction, the US dollar went up in value from F$1.76 to F$2.19. Until another official change, the exchange rate is allowed to fluctuate within a permissible band.

Currencies of advanced countries are flexible currencies. Their price varies on a daily basis, even on hour to hour basis, just as the price of any commodity, apples or gold.

Supply and demand

Under a flexible exchange rate regime, the interaction between forces of supply and demand determines the value of the currency.

If Aussie dollar goes up in value in terms of the US dollar, it is due to an increase in demand for the Australian currency relative to its supply. Supply of the Aussie dollars is represented by Australian imports from overseas; and demand for Aussie dollars by demand for its mineral exports and other products and services. So the result of an increase in demand for Aussie dollars relative to supply is the rise in its value in terms of the US dollar.

In these uncertain days, when the Eurozone is faltering and the Japanese economy is yet to recover from its two decade-long recession, there is another factor to consider. Following the expansion of money supply in
USA, Japan and others, as part of response to the ongoing recession, known as quantitative easing, their currencies are increasingly debased. Fears of inflation fuel the expectations of further depreciation of their currencies.

The Aussie dollar benefits from these fears. Just as the boat people seek asylum in Australia, jittery savers the world over and currency speculators rush to hold the Aussie dollar. This is known as the safe haven factor.

In addition, every bit of good news about the Australian economy pushes up the value of the Aussie dollar. The news that Australian trade deficit narrowed to A$178 million in from A$1.2 billion was due to rise in exports by three percent and fall in imports by one percent. The market immediately reacted. The Aussie dollar rose to US1.0469 from US$ 1.0449.

**Pros and cons**

Aussies travelling overseas love their rising currency. They can get more foreign currency for every Aussie dollar they exchange. Consumers are also happy as a higher dollar makes imports cheaper. Lower import prices keep inflation down.

Further, it helps contain official interest rates for longer. In fact, that was one of the reasons that prompted the Reserve Bank of Australia to maintain the benchmark interest rate unchanged at the historically low rate of three percent, the lowest since the 2008 financial crisis.

On the other hand, the rising Aussie dollar makes exporters unhappy. Exports become more expensive to importers overseas. Mineral exports have become insensitive to price changes due to insatiable Chinese demand. They are bringing more money to Australia than before. The traditional exports such as agricultural products, beef and fruits and tourism are likely to lose.
Need for niche markets

Fiji knows the rising Aussie dollar buys more.

A major part of Fiji’s foreign exchange earnings come from tourism. Promotional efforts are needed in view of the stories that Australians are booking more trips to the UK as the Aussie dollar hit a 28-year high against the British pound, with other popular destinations being Thailand and Bali.

This may be true for older people who want to have a longer holiday in Europe; and couples and singles with exotic trips to Southeast Asia. Fiji’s attraction will continue and remain unbeatable in terms of a shorter vacation packed with exciting things for the young family with kids in a safe setting. With North Korea’s sabre rattling, and Asia becoming a hotter place in terms of the oncoming summer heat, Fiji is the best place for Aussie tourists.

Another encouraging piece of news was about Fiji’s apparel industry.

The New Zealand High Commission trade official made a very timely observation that he was impressed with the progress of Fiji’s apparel companies in terms of supplying corporate wear to Australia and New Zealand.

“Countries such as China, which are concerned more with large supplies, would not be so interested in the small niche markets that Fiji had entered.” That underscores the need for building and maintaining a stronghold on small niche markets.
Anything in excess is considered unhealthy. This is true for human beings and economies. Excess intake of sugar, fat or protein leads to health complications just as lack of them leads to poor nutrition.

Large inflows of foreign exchange lead to appreciation of exchange rate in countries with flexible exchange rates, such as Australia. In the case of countries with fixed exchange rates, such as Fiji, large inflows of foreign exchange lead to rise in money supply and inflation.

Both hurt export competiveness.

Appreciation of exchange rate, although it makes imports cheaper, renders exports unattractive. Inflation makes exports unattractive, as they become pricier to the rest of the world.

The dilemma

The dilemma, before Papua New Guinea (PNG), which has a flexible exchange rate regime, arises from a classic case, known as “Dutch disease.”

PNG is the resource rich country amongst Pacific island nations. Aside from relatively large land area (463,000 sq km) with a population of 7 million and GDP of US$13 billion, compared to Fiji (194,000 sq.km), and population of 850,000 with GDP of US$ 3.8 billion, PNG’s mineral and non-mineral resources are considerable.

PNG’s exports are more diversified and dominated by minerals: oil, gold, copper ore. Others are agricultural: logs, palm oil, coffee, cocoa, crayfish and prawns.

When world prices for oil and other minerals were rising, the mineral exporting countries all over the world and in our region, Australia and PNG were doing well. The commodity price boom brought prosperity. When the world recession set in, in 2008, following the global financial crisis in USA, China, however continued to grow. That helped Australia and PNG to do well with their mineral exports to China.
In addition to mineral export earnings, PNG has been attracting foreign direct investments. One of them is the liquefied natural gas project (LNG) for US$ 19 billion, which is nearing completion. The spin-off effects of construction include increases in the non-mining private sector investments, especially in real estate. These have been bidding the prices of non-tradeables such as labour, water and electricity and in the process they reduce the profitability of investment in traditional, non-mineral exports, which include agriculture.

**Dutch disease**

The term owes its origin to the Dutch economic crisis of the 1960s, consequent to the discovery and exploitation of North Sea natural gas. Rising foreign exchange inflows push up the value of domestic currency and the resultant appreciation makes the country’s traditional exports less price competitive to overseas consumers. Further, currency appreciation encourages large cheap imports, killing domestic industries. It even leads to de-industrialisation as they would shift to other countries with lower costs of inputs, including labour.

**Re-balancing**

Early this week, releasing the central bank’s latest Economic Bulletin, Governor Loi Bakani expressed his concerns about the effects of Dutch Disease and the likely impact of winding up of the construction phase. Referring to the latter, he cautioned that since labour and equipment engaged in the project would be laid off, the government should utilise the labour and equipment for its development infrastructure projects.

As regards the effects of Dutch disease, the central bank Governor urged government to invest the gains into developing the agricultural sector. The foreign exchange reserves at the end of March 2013 were US$ 3.7 billion, equivalent to 10.9 months of total imports of the country. He said: “To have a sustainable economic growth, the Government must heavily invest and develop the agriculture sector including other non-mineral private sectors so that in the long run growth must be underpinned by these sectors rather than developments in the mineral resource sector.”
If the re-balancing does not take place, high import demand for consumption goods could exert downward pressure on the exchange rate and lead to an increase in domestic prices. Governor Bakani warned in clear terms: “The current problem, however, is not of the Kina appreciating but of it depreciating, pushing up prices of imported goods.”

So, that is the dilemma before the nation: to re-invest valuable foreign exchange in non-mineral sectors, including agriculture and rural projects raising rural incomes and reducing unemployment and migration to urban areas or fritter them away on consumption imports?

Governor Bakani did not indicate a third option, which would be up in his sleeves: The central bank can purchase foreign exchange by selling kina and mop up the surplus kina by open market sales of securities. Known as sterilised intervention, it may leave the money supply unchanged. There will be no change in exchange rate as well.

The first option is the best option: re-balancing.

That is the buzzword everywhere!
Banks caught in the LIBOR scandal in 2010-12 are involved again in another scandal. It is now the rigging of foreign exchange rates.

Earlier it was the rigging of LIBOR.

LIBOR is an acronym for London Interbank Offered Rate. It has no connection with the interbank lending rate, fixed by a central bank, around which interest rates charged by commercial banks revolve. Also known as Fed Funds rate in US or Official cash rate, it is determined through open market operations by the central bank.

LIBOR coexists with benchmark interest rates of central bank.

The LIBOR is set by a panel of 18 banks for ten currencies and for 15 maturities. It is fixed each day by taking estimates from the panel of what they would have to pay to borrow if they needed money. The top four and bottom four estimates are discarded. LIBOR is the average of those. It is announced each day at 11.45 GMT. It is used as the reference point for financial instruments including variable mortgages, small business loans, student loans and credit cards.

LIBOR’s influence is wide and large as the daily dealings are about US$360 trillion per day.

**Rigging of LIBOR**

Much before the 2008 financial crisis began, the banks found it convenient to submit false estimates instead of honest estimates. By doing so, they can gain or lose money depending on the level at which LIBOR was set each day. Weak banks would not like submitting honest estimates of the high price they would have to pay to borrow. Richer banks tried to influence the final LIBOR fixing to increase profits (or reduce losses).

So, there was incentive for rich or weak banks to lie.
The rigging went unnoticed until 2010. Those paying interest on loans benefitted from lower LIBOR rates. Savers and investors, such as pension funds and hedge funds, lost out.

With the collapse of Northern Rock in England in 2007, with central bank concerns on liquidity, LIBOR received due attention. The rigging was detected and banks were identified by investigations conducted by the Financial Services Authority of UK. The Barclays eventually admitted. That led to UK and USA governments imposing fines totaling £290 million.

Legal interpretation was different. A US court held that participation of 16 banks in a panel was only a cooperative process. Banks provided daily estimates. The price quoted was not a bid and nothing was bought. So, the decision was that competition laws did not apply.

Maybe that was the reason behind former Bank of England (BoE) Governor Mervin King’s description of LIBOR rigging as “spot fixing”, and not as serious as “match fixing”!

LIBOR rigging did not affect Fiji or any Pacific island country (PIC), as there has been no interbank borrowing across the border. PICs have exchange controls. Their currencies are not traded.

**Latest scandal**

The rigging of the foreign exchange market is worrisome.

World merchandise trade is around $20 trillion per year. The foreign exchange market is huge, dealing with more than US$ 4.5 trillion worth of currencies every day, 40 percent of which is in London.

The exchange rate rigging has been detected in the very chat rooms of traders who fixed LIBOR! The BoE Governor Mark Carney was upset, when he heard that one of his own staff knew but failed to report it.
Besides suspending the employee, the Governor announced a shake-up and created a new position of deputy governor responsible for banking and markets. Last week, the Swiss competition commission began investigation into Swiss, British and U.S. banks, including Citi, Morgan, UBS and Credit Suisse.

The BoE does not regulate the forex market.

Its objective is to ensure the stability of the pound with appropriate monetary policies. Values of floating currencies, including the pound are determined by market forces of supply and demand.

How to deal with exchange rate rigging is a question before all advanced countries.
The well-known American writer and humorist, Mark Twain once cautioned: “Put all your eggs in the one basket, and WATCH THAT BASKET.”

The basket of currencies, which central banks under the fixed exchange regime including Reserve Bank of Fiji, have adopted for maintaining the value of their respective currencies, is not a fragile one. The basket of currencies comprises the sturdiest of sturdy currencies of the world. They are of the world’s leading economies, which export to the rest of the world goods ranging from machinery and high tech goods and services to manufactured goods of all varieties, covering daily consumption.

The currencies included in the RBF’s currency basket are the American dollar, the euro, the Japanese yen and of course, the Australian dollar. Before the birth of the euro in 1999, the British sterling was one of the currencies included in the basket, which was replaced by the euro. To the list of these currencies, we now see the possibility of adding the Chinese currency, the renminbi.

In October 2010, Fiji’s Minister for Foreign Affairs, Ratu Inoke Kubuabola announced at the end of his visit to China that the renminbi would be included in the basket of currencies. It signifies the recognition of the growing importance of the renminbi in Fiji’s trade and investment relations with China.

Why basket of currencies?

Small island states, whose dependency on external trade is very high for all goods ranging from food and fuel to capital goods, prefer to keep a stable exchange rate so that fluctuations in external value of currencies of the source countries do not affect the value of imports and exports. A stable exchange rate was achieved in the past under a fixed exchange rate regime by linking the country’s currency to that of the most important trading partner country.

Before World War II, many countries linked their currencies to the British sterling, as Britain was the then dominant economic power. With the decline of British dominance, and with the emergence of the US dollar as a
major currency soon after the end of World War II, they switched to linking their currencies with the US dollar.

Currency crises including the Asian currency crisis of 1997-98 exposed the weakness of a link to one currency, which was the chief reason for the near collapse of the Asian economies.

For example, in 1997, the Thai economy was pushed into a deep decline, when its current account balance (which comprises trade and service accounts with income transfers) became adverse and the liabilities in terms of the Thai baht became large. Since the baht was linked to the US dollar, with the continued depreciation of the floating US dollar, the Thai baht liabilities steadily ballooned. As rumours spread that Thailand would not be able to meet its external repayment obligations, there was a run on the Thai economy. As investors began to pull out, the Thai currency collapsed.

In the reform years that followed during the 1997-1998 Asian currency crisis, Thailand and Malaysia and others switched on to linking to a basket of currencies rather than one currency. The purpose behind this move is to minimise the impact of violent fluctuations in the currencies of trading partners, since the fluctuations in world currencies are not all in the same direction. By having a basket, the impact of gyration in one currency is offset by the movements in others. Linking to a basket of currencies is a prudent step to minimise the volatility in the currencies of trading partners.

Fiji’s basket

The exchange rate, which is calculated on a daily basis, is announced by the RBF primarily in terms of the US dollar. For watching the movements in exchange rates of currencies included in its basket over a period, say a month, RBF calculates the monthly average rate by way of a weighted index number. The weights used are the percentages of trade with respective countries, whose currencies are included in the basket.

The index so calculated is known as the nominal effective exchange rate (NEER) and movements in the NEER would show the variation in exchange
over a period of time. For assessing Fiji’s competitiveness, another index number known as the real exchange rate (REER), incorporates changes in the relative price levels.

**The case of the renminbi**

Fiji’s trade with China has increased substantially over the past years. In terms of percentage to total trade, Fiji’s trade with China in 2009 is 4.3%, more than trade with Japan (3.6%) and not very far from trade with USA (6.9%).

As China has also emerged early this year as the second largest economy in the world, next only to USA by pushing Japan to third place, its currency renminbi has to be recognised. It is China, this is propelling the Australian economy. But for China’s growing appetite for its mineral resources, Australia would have just been any other industrialised country, currently in the doldrums.

So there is every justification for the growing importance of the renminbi. However, there is one essential ingredient missing here.

Capital controls continue to exist in China. The renminbi is not fully convertible. Furthermore, it is not floating and is pegged to the US dollar. It is not determined by market forces of supply and demand. In fact, that is the bone of contention.

All the advanced countries, including USA, Japan and the European Union, want the renminbi to be up valued, if not floated immediately. It is contended that China has deliberately kept the currency undervalued by 50%. Thus, currencies already in Fiji’s basket and renminbi, which is proposed to be included, do not belong to the same category. However, inclusion of the Chinese currency in the basket would not matter much.

The Seoul meeting of the leaders of twenty governments known as the G-20 scheduled in November 2010, was scheduled to discuss the subject. If the G-20 Meeting successfully resolves the ongoing currency conflict,
and if China decides to float its currency, thereby joining the elite group of floating currencies, there will be every justification for inclusion of the renminbi in Fiji’s currency basket.

It looks improbable, but nothing is impossible. China’s emergence as the world’s second largest economy next only to the USA looked improbable just a few years ago.

Things do change. Recall the words of Benjamin Disraeli: “Change is inevitable in a progressive society. Change is constant.”
This week our focus is on the fear of appreciation of Papua New Guinea (PNG)’s currency, the kina.

Under a fixed exchange rate regime, domestic currency can be up-valued or devalued only by the central bank.

PNG has a floating exchange rate regime under which the value of the kina is determined by free interplay of market forces of supply of and demand for kina. The supply of kina is influenced by imports and demand for kina by exports. If imports exceed exports, the value of kina goes down and if exports exceed imports, the value of Kina goes up.

Countries under flexible exchange rate regimes, including the USA and Japan, do interfere with market forces for arresting, either the depreciation or appreciation of their currencies.

Depreciation renders imports more expensive but makes exports cheaper. It thus discourages imports and encourages exports, thereby reducing trade deficit.

As USA was going through recession, the only way for stepping up production and creation of jobs is to export more. The US central bank pumped in more than one trillion dollars during last five years, cheapening the currency. The US dollar depreciated against all currencies of the world.

The US simply allowed the dollar to have a free fall, known as “benign neglect”. The USA has been doing it for last five years: all for creating employment.

The export-dependent Japan did not like the yen appreciating. Japan did not want its exports becoming uncompetitive. So it intervened, selling yen and purchasing dollars. Selling the yen for dollars depreciates its value.

This way of intervention in exchange market is called “dirty float”.
Kina before Liquefied Natural Gas Project

During the past five years, the kina was depreciating against major currencies, because of the fall in export earnings due to low international commodity prices following the world recession in 2008. That benefitted PNG farmers. But the costs of imports rose. There was domestic inflation, since PNG heavily depends on food imports.

The central bank, Bank of PNG (BPNG), took various measures for stabilising the kina. They included a tight monetary policy stance with the benchmark interest rate at 6.25 percent. PNG grew in 2013 at a slower pace. In 2013, the kina came under downward pressure due to lower export receipts and higher import demand, and ongoing payments related to the PNG LNG project.

The kina depreciated by 12.6 percent against the US dollar between March 2013 and March 2014.

LNG project

The situation has now changed with the completion of the US$19 billion liquefied natural gas (LNG) project (life of 30 years and nine trillion cubic metres of gas). On May 27, PNG witnessed the first shipment of gas for Japan. Total income from the LNG project will be US$31 billion, with one-third expected to remain in PNG. Most of it will be as tax revenue, dividends, royalties and infrastructure tax credits to the national government, provincial governments and landowners. The government revenue will grow by around US$3 billion to $4 billion in a full calendar year and the country revenue will grow by a record 21 percent.

With massive export earnings, the kina is bound to appreciate. Although imports will become cheaper when the kina appreciates, the exporters of tree crops and all non-mineral exporters would be experiencing losses, as their exports would become more expensive.

Further, with increases in export incomes, demand for non-traded goods
will rise. These include house rents, water, electricity and domestic labour, contributing to inflation. The result will be a rise in the real exchange rate, reducing competiveness of agricultural exports further. The poorer sections of the community depend upon incomes from agricultural exports. This phenomenon is known as Dutch disease, a term which refers to the consequences of a similar natural resource discovery in the Netherlands.

**Intervention**

Can BPNG intervene and buy up incremental exports earnings for domestic currency?

That will be inflationary as more kina will be in the hands of the public. So, the so called sterilised intervention has to be resorted to, for offsetting the rise in money supply, by sale of kina bonds for absorbing excess kina from the public.

It is a sophisticated exercise. With observed limitations in the financial sector, that will only test the BPNG’s capability.

The best option is to utilise the rising revenue by launching massive rural development programmes of electrification, roads and communication, education, and health. That will eventually improve the quality of life in rural areas, and ensure equitable distribution of benefits from the LNG project.
November 2008 was truly a remarkable month.

It witnessed the historic election of a non-white to the highest office in the United States.

Secondly, there was seismic shift in global hegemony at the G-20 summit signifying the end of world dominance by seven rich countries and the European Union.

One more record was made on 20 November when the IMF approved a loan for a Western European nation for the first time since 1976. In the past three decades, such loans were normally for third world countries.

Industrialised countries were ever ready to preach on monetary, fiscal and exchange rate management matters to the rest of the world. This time the dubious distinction of being preached to fell on Iceland, geographically very near to UK, whose financial sharks were also equally responsible?

The two-year IMF loan of US$ 2.1 billion is for “restoring confidence and stabilising the economy of Iceland.”

There are other European nations including Ukraine, Hungary and Turkey on the waiting list of IMF borrowers, as well as Pakistan in the third world.

**Globalisation: a leveller like death!**

Strangely enough, Iceland’s financial crisis has nothing to do with the housing bubble in USA.

Iceland’s three major banks avoided the troubled mortgage securities which brought Wall Street to its knees, but expanded aggressively at home and abroad.

It was due to the heady homebrew of a mix of domestic financial aggression and neighbouring British depositors’ greed for making a quick buck, aided by poor banking laws.
It ended finally in the takeover of the banking system by government: the ultimate levelling of institutions, as witnessed in the nationalisation of Northern Rock in UK and the bailout in USA.

**How it all started**

As a North Atlantic island country, Iceland (area 40,000 sq. Miles with 320,000 people) was traditionally known for whaling activities. Following an international moratorium, it abandoned whaling and concentrated on fishing. Its major exports were cod and haddock to Britain and Germany but though close to Europe, Iceland did not want to join the European Union. While Iceland’s growth was due to fishing, as fisheries showed signs of gradual contraction in early 2000s, the country wanted to diversify by attracting foreign investment in other areas.

Investors such as Alcoa built giant aluminium plants utilising the country’s cheap, clean hydro energy. From 2002, Iceland deregulated its commercial banking. The three banks that make up almost the entire banking system went wild attracting savers from Europe, offering high interest on savings accounts.

Money poured in from UK in response to the lure of high returns. More than 120 British municipal governments, universities, hospitals and charities and even British police forces sent their deposits. Total UK deposits in Iceland banks at one time were estimated around £4 billion.

The Icelandic banks did not invest in US subprime mortgages but went on their own lending binges. Soon, Iceland underwent a metamorphosis from a fishing economy into a super North star of the global economy, holding assets nearly 10 times the nation’s gross domestic product.

With borrowed money and profligate consumption, Iceland became another American economy. Its prosperity grew to reach an annual per capita income at US$54,000 in 2007. As Oscar Wilde wrote, “Nothing succeeds like excess!”
As the credit crunch spread across the globe with the failure of institutions in USA and UK, rumour mongering began in early 2008. Financial speculators started worrying whether Iceland’s three banks would default on huge foreign loans. As speculation became rife, Iceland’s currency, the krona, began to depreciate. The situation deteriorated into a crisis of confidence in Iceland’s ability to maintain the financial system.

That was sufficient. British depositors began to pull out their funds.

As Iceland’s banks pulled their shutters down, depositors moved the British government to repatriate their savings. Soon the situation degenerated into a diplomatic dispute with the UK. The British government invoked antiterrorism laws in October in an effort to get the money back from Iceland!

The central bank had foreign reserves of only US $2.5 billion.

As Iceland became nearly bankrupt and its currency went down in value by half, a loan from the lender of last resort, the IMF, was necessary.

Out of an estimated requirement of US$6 billion to handle the meltdown, IMF would provide a two year loan of US$2.1 billion to meet the banking crisis, besides stabilising its currency and overhauling its financial regulation system.

Following the IMF announcement, Finland, Sweden, Norway and Denmark promised they would lend Iceland an additional US$2.5 billion.

In the meanwhile, the economic projections are: Iceland would contract by 2.5 percent in 2009 after growing 3.8 per cent in 2008 and would decline by 1.5 percent in 2010. The IMF intervention in Iceland marked the most unexpected reversal in the country’s fortunes after a decade-long, debt-fuelled binge by the country’s banks, businesses and some citizens.

**Globalisation giveth and it also taketh away!**

As Thomas Friedman wrote in New York Times, “Now we have to hope that globalisation will saveth!”
In late June 2014, there were two developments of relevance to small island developing states (SIDS), including Fiji and other Pacific island countries (PICs), focusing on foreign direct investment (FDI).

One was the release of the World Investment Report 2014 (the Report) by United Nations Conference Trade and Development (UNCTAD) based in Geneva; and the other was the annual conference of the joint Fiji-New Zealand (NZ) Business Council and NZ-Fiji Business Council held in Suva.

Foreign direct investment

If a domestic resident invests in his own country, it is called domestic investment. If the investment is done in another country, it is known as foreign investment. Investment is of two kinds: short term and long term. The short term portfolio investments are buying either the newly issued or already issued bonds or shares in secondary market in pursuit of return, which consists of interest or dividends and capital gains from the selling of the purchased bonds or shares.

Portfolio investments are unstable. If the interest rate falls, investors pull their funds out of one country and move to another with higher interest rate. Instability of flows has made them known as hot moneys. That results in depreciation of their currencies.

On the other hand, long term foreign direct investment (FDI) inflows are durable. They are investments in manufacturing, services by setting factories, hotels/ resorts, involving use of land and labour and other local raw materials. The gains or profits would flow only after a gestation period. The gains are spread over years and hence FDI cannot be pulled out so easily as hot money.

PICs welcome FDI for two major reasons: they are (i) non-debt creating and (ii) real resources. They supplement domestic savings for greater investment for raising employment opportunities and production of goods and services not only to meet domestic demand but for exports. There is no repayment or servicing obligations of the kind associated with debt. FDI inflows bring valuable foreign exchange and hence real resources to supplement limited
foreign exchange reserves.
Other advantages of FDI are:
(i) transfer of superior technology;
(ii) better management skills; and
(iii) training and learning opportunities for the locals.

How much the recipient country would open up its economy to FDI is a policy question. Some countries exclude certain sectors for national security reasons.

Traditionally, FDI in PICs was confined to the natural resource sector such as sugar, tourism and more recently telecommunications and retail trade such as supermarkets. Some PICs were selective too. FDI in local tourism tour operations, taxi services and the like where local resources are adequate, is prohibited.

**World Investment Report 2014**


The Report discusses how future FDI flows would fit into the sustainable development goals (SDGs) which would replace Millennium Development Goals by 2015. SDGs will have targets for 2015–2030 for poverty reduction, food security, human health and education, climate change mitigation, and other objectives across economic, social and environmental sectors. For meeting SDGs, the Report estimates annual investment requirements of US$3.3 trillion to US$4.5 trillion. At the present levels of FDI and domestic investment, an annual investment gap of US$2.5 trillion is foreseen.

Aside from inadequacy of public sector funding and low private sector participation, FDI’s role in SDG areas is meager. “Only a fraction of the worldwide invested assets of banks, pension funds, insurers, foundations and endowments, as well as transnational corporations, is in SDG sectors, and even less in developing countries, particularly the poorest ones”.

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How to mobilise and re-direct FDI in these sectors will be a challenge.

**Fiji situation**

Fiji has been experiencing a decline in FDI inflows. From US$341 million in 2008, it decreased to US$164 million in 2009. After some recovery, FDI in 2013 was US$272 million.

Ministry of Industry and Trade permanent secretary, Shaheen Ali told the joint Fiji and NZ Business Council meeting that NZ FDI in Fiji is stagnant despite the lowest of corporate taxes and the number of tax free regions.

The UNCTAD Report notes the subject of incentives is controversial.

What is needed is assurance of stability, enforcement of property rights and contractual obligations and quick legal remedies, all amounting to good governance.

Further, the Report advises tie-ups with metropolitan countries for promoting greater FDI inflows. The Pacific Closer Economic Cooperation and plus (PACER Plus) presents such an opportunity.
Before looking at future strategies both in the immediate and long run for promoting deeper economic integration among Pacific Forum countries, it would be worthwhile to take stock of developments in the two regions: the Caribbean and the Pacific.

The Caribbean is more integrated than the Pacific region. Commitments on CSME have been extensive and considerable progress has been made in terms of free trade, although some obstacles remain in terms of exclusion of some agricultural products and continuance of quotas.

While observing that a significant agenda still remains to be implemented, a recent World Bank study (2005) notes there has been significant progress in liberalising trade in labour services among CARICOM countries.

**Draft Pacific Plan**

However, progress in the Pacific has been slow. There has been no serious commitment to regional integration of the kind witnessed in terms of the original Treaty of Chaguaramas or the revised treaty to usher in CSME.

The main reason behind this, which is the basic difference between the efforts towards economic integration in the Caribbean and the Pacific regions, is that while CSME is totally CARICOM driven, integration efforts all along and the present Draft Pacific Plan are not solely PICs determined. It is apparent the draft Pacific Plan has been influenced by the Australian and New Zealand governments’ concerns on regional security and stability.

Although the title of Pacific Plan is obviously different from the earlier one: A Pacific Economic and Political Community, coined by the Australian Senate Committee, the ingredients of the Pacific Plan, which are called four pillars

- Governance
- Security
- Growth
- Sustainable development

are just the same.
They reflect the particular concerns of the two major metropolitan powers, which happen to be the founding members of the Forum.

Since the two advanced Forum members are major aid providers, PICs feel any step towards integration of the region would not but be mainly conferring benefits on Australia and New Zealand, and hence there is a reluctance to go along the full way with them. “What is in it for me?” is the question that has been haunting PICs.

Perceptions of small PICs have been that any deeper regional integration, as in the past, would be benefiting only major PICs, such as Fiji and hence the apparent unwillingness to display a show of support.

The failure of regional airlines and poor performance of the regional Pacific Forum Shipping Line and the resulting tensions were pointers.

A major breakthrough was achieved for promoting tourism in terms of the successful conclusion of the Pacific Islands Air Services Agreement (PIASA). However, Fiji to the disappointment of others, in particular the small PICs, was reluctant to join PIASA.

**Costs and gains**

Participating PICs in free trade and deeper integration will naturally weigh their gains and costs.

Even among a subset of PICs, the Melanesian Spearhead Group, both Solomon Islands and Vanuatu feel the MSG Trade Agreement benefitted only Fiji.

Group perceptions of small PICs have been that past efforts including the MSG Trade Agreement have benefited only bigger PICs. On the other hand, all PICs have the feeling that any of the past regional integration moves were in the interest of and were influenced by Australia and New Zealand.

The suspicions come to surface from time to time as when Solomon Islands voted along with Japan on 21 June 2005 for resumption of commercial
whaling. Looking back, both Australia and New Zealand did the right thing by stepping aside when PICs decided to have a separate trade agreement aiming at FTA among themselves by 2010.

It would again be appropriate for Australia and New Zealand to consider not rushing into negotiations with PICs, although legally they can do so if PICs, in their negotiations for EPA, trigger PACER earlier than 2011.

The objective of PICTA is to foster trade and closer relations among PICs themselves without the two advanced countries so that they can use it as a stepping-stone. Australia and New Zealand will do well to let that happen. Eventually negotiations for closer relations paving the way for free trade and ultimately regional integration will have to begin under PACER after 2011.

Meanwhile, Australia and New Zealand can look at their immigration laws and provide special access on temporary work permits for unskilled farm labourers to work on their farms.

Any gestures of a substantial nature in this regard will be of immense help in confidence building.

Priorities both single market and single currency are advanced concepts for which PICs are not ready yet. Although single market and single currency were adopted as the goals of the CARICOM a long time ago, progress is understandably slow, as they involve sacrifices of some measure of sovereignty. Aside from sovereignty issues, empirical studies on the feasibility of a common currency for PICs, either on their own or by adopting the Australian dollar, have indicated there has been no convergence observed in any economic real variables, such as gross domestic products, inflation and real exchange rates of the PICs and Australia and New Zealand.

External shocks experienced by PICs and Australia and New Zealand in the past have been asymmetric in nature and make them unsuitable candidates for a common currency at this stage, since common fiscal, monetary and exchange rate policies would not be appropriate either for PICs or for the union as a whole.
Although it could be argued that most of the real economic variables such as real exchange rates are endogenously determined and hence a common currency can be adopted (Duncan 2005), one has to recognise the presence of inherent risks that are likely to be far greater than the anticipated gains.

There will be no easy exit from a common currency arrangement once established and it will only be at a very high cost.
The Pacific Islands Forum held its 39th Meeting in August 2008 in Niue minus Fiji. It was certainly a momentous meeting because it was unique.

Politics dominated the deliberations, beginning much before the meeting, ending with an unprecedented communique.

In the views of many, it was called very “UnPacific”. It indicated, for the first time, the possibility of suspension of a founding member nation -- one that is also hosting the Pacific Island Forum Secretariat -- in the event of failing to fulfill a commitment. As a play on an old American commercial jingle about Salem cigarettes goes, “You can take Fiji out of the Forum, but you cannot take the Forum Secretariat out of Fiji!”

That was unless the two metropolitan powers had already made alternate arrangements to accommodate the secretariat on their shores.

Benjamin Disraeli in a House of Commons debate observed. “Finality is not the language of politics” and anything could happen before March 2009.

As another equally distinguished Englishman, Joseph Chamberlain noted, “In politics, there is no use looking beyond the next fortnight.”

So the idea was for us to wait for the dust to settle and the steam to cool off.

Meanwhile, a review of what happened at the Niue meeting showed a few positive things.

**Seasonal farm jobs**

Australia announced its own pilot scheme for seasonal workers from one country each from Melanesia, Polynesia and Micronesia. The scheme is based on the successful experience of the New Zealand scheme of Recognized Seasonal Employers.

The Australian three-year pilot scheme will place up to 2500 workers from Vanuatu, Tonga and Kiribati in horticultural work in Australian regional...
areas with identified labour shortages.

In the midst of growing unemployment and rising poverty levels in the island countries, provision of farm labour opportunities enables families in island countries to receive remittances in a steady manner. Under the scheme approved by the Australian Government, visas issued will allow islanders to work in Australia for seven months in a year.

**Infrastructure Fund**

At the Niue meeting a much awaited initiative, known as the Pacific Region Infrastructure Facility was announced. The facility will be jointly funded by Australia, New Zealand, the Asian Development Bank and the World Bank.

The objective of the facility is to assist island countries improve roads, ports and general transport and support reliable energy and communications infrastructure, water, sanitation and waste management systems. It will provide funding of up to $200 million over four years.

**Bulk procurement**

In the context of surges in oil prices combined with its high volatility, the Pacific islands should adopt a joint, competitive tendering procedure for importing oil. Such a combined bulk procurement program will assure them of lower prices than those at which they currently procure oil from supply sources.

The bulk petroleum procurement idea has been on the cards for several years. The Niue meeting confirmed the possibility of making more solid progress as details of a scheme was to be hammered out in the October 2008 Forum Finance Ministers meeting.

**Partnerships**

Australia signed two agreements, one with Papua New Guinea and
another with Samoa, marking a new approach. The agreements are called Partnerships for Development and provide aid to island countries, conditional to fulfilling certain identified commitments to improve their economies. Australia has planned to sign similar agreements with eight more island nations.

The agreement was for both PNG and Samoa to receive Australian aid in specific areas, such as providing better access to markets and services, universal education, improved health outcomes and better public administration, strengthening law and justice agencies and private sector-led growth.

**Unfinished tasks**

Many tasks remained. These include implementation of the Pacific Island Countries Trade Agreement (PICTA), envisaging free trade by 2010 amongst island countries, keeping Australia and New Zealand out, through countries implementing required steps beyond mere ratification; and conclusion of the Economic Partnership Agreement with the European Union by December 2008. The latter would trigger negotiations with Australia and New Zealand toward the ultimate free trade area concept, raising in the first place the question about the usefulness of PICTA, as a stepping stone.

Above all, there remained the Pacific Plan, which was assiduously prepared with single-minded devotion by the former secretary general, Greg Urwin. The Pacific Plan is a scheme of co-operation based on four “pillars”: economic growth, sustainable development, good governance and security. It incorporates many of the components of regional economic integration including free trade in goods and services and regional cooperation in areas including fisheries, food security and transport.

When the annual jamboree was over, Pacific island leaders back in their home countries surely pondered over what they failed to achieve towards the goal of regional integration. Were there other missed opportunities as well?
When the new secretary general and his staff solemnly gathered for a memorial service on 27 August at the Forum Secretariat headquarters in Fiji to honour and celebrate the life of Greg Urwin, the sombre words of Robert Frost could have inspired them:

“The woods are lovely, dark and deep.
   But I have promises to keep,
   And miles to go before I sleep,
   And miles to go before I sleep.”
September 2012 marked two major milestones in the history of economic co-operation in the Pacific.

These two milestones relate to deepening sub-regional economic integration of four Melanesian Spearhead Group (MSG) countries: Fiji, Papua New Guinea (PNG), Solomon Islands and Vanuatu. The MSG countries’ combined total population is about 9 million or 90 percent of the Pacific’s total population. The milestones are in regard to mobility of skilled labour, and trade in goods under the MSG Trade Agreement (MSGTA).

In 1986, PNG, Solomon Islands and Vanuatu came together for promoting closer political ties. Economic co-operation received attention only seven years later. The MSGTA was signed in 1993 for promoting free trade in three products: tea (a major export of PNG), canned tuna (a major export of manufactured product of Solomon Islands) and beef (a major pastoral export of Vanuatu).

**Formidable force**

The MSG became a formidable entity soon after Fiji joined the group in 1998. During the next three years, 180 more products were covered under free trade. In 2005, a revised agreement was adopted for further integration of the economies of four MSG countries, with greater mobility of skilled personnel between MSG countries.

The military coup of 2006 in Fiji and the isolation of the country through political and economic sanctions gave a big boost to MSG solidarity. Negotiations led to signing of the MSG constitution in 2007 and establishing the MSG Secretariat in Vanuatu in May 2008. There was a renewed emphasis on greater economic integration not only in trade but also in services. It was agreed to liberalise the negative list of goods, reducing to zero tariffs by January 2013. The MSG TA also provided protection to ‘infant industries’ on the basis until such time they can grow and compete with goods from trading partners.

In March 2012, a Memorandum of Understanding on Skills Movement Scheme was signed for facilitating the movement of skilled MSG workers.
for temporary employment in MSG Countries. The SMS became effective September 30. Under this, trained teachers and nurses, engineers, accountants, pilots, doctors as well as those with specific trade skills would move to work within MSG.

On 13 September, by a Gazette notification, PNG removed 400 items in the negative list of goods. This means these items will be imported into PNG duty free from other MSG countries. Others in the list will continue to be protected would include mackerel, salt and sugar.

Thus, these two developments make the MSG TA more meaningful amongst all the existing regional trade agreements. The latter include Pacific island Countries Trade Agreement (PICTA) amongst 14 Pacific island countries and Pacific Agreement on Closer Economic Relations (PACER) and its subsequent revision as PACER Plus, with Australia and New Zealand, both signed in 2001. As far as other MSG countries, Vanuatu will remove tariffs on its negative list by 2013, while Solomon Islands will do that by 2017. It is to be noted Fiji has no negative list, which means goods from PNG, Solomon Islands and Vanuatu countries can enter Fiji free of duty.

At one time, sub-regional cooperation was looked upon as too parochial and divisive a step on the grounds that it is confined to a group of countries ethnically more united and political. However, it has now emerged to be more acceptable not only in Melanesia but elsewhere because of the dragging of PACER Plus negotiations and exclusion of Fiji.

**The Caribbean example**

One can look at the experiences of another region. In the Caribbean region, Caribbean Community (CARICOM) with around 16 million people is an organisation of 15 independent Caribbean nations and various dependencies, similar to our region’s Pacific Islands Forum, regional integration efforts were intensified because of the success of a sub-regional effort. Seven member states (Antigua and Barbuda, Dominica, Grenada, Montserrat, St.Kitts and Nevis, St. Lucia, and St. Vincent and Grenadines and two associate members (Anguilla and British Virgin Islands), with
about 700,000 people came together and set up the Organization of Eastern Caribbean States (OECS) in 1981. It is a common market with a common currency. The Eastern Caribbean dollar, which is pegged to the American dollar is one of the most stable currencies of the world (1 US$ = EC$ 2.76) since 1976, when the Eastern Caribbean Central Bank was set up.

CARICOM leaders always refer to OECS experiences.

**Melanesian example**

The MSG experience is now hailed by no less than the prime minister of Samoa. In his keynote address on Pacific Regionalism: A Tale of lessons, identity and boundless opportunities at the Pacific Islands Forum 40th Anniversary Leaders Lecture Series held in Apia this year, Prime Minister Tuilaepa Sailele Malielegaoi declared: “Melanesia has led and shown the way in establishing sub-regional groups”.

Citing the contribution of MSGTA to the economic integration of the sub-region as complementing and re-enforcing region-wide efforts to address issues and problems facing the whole Pacific, the Samoan leader acknowledged the importance of sub-regional effort thus:

“Besides the preservation of languages culture and traditions, sub-regionalism may also provide better platforms for the effective and efficient delivery of programmes that not only benefit the immediate sub-region but the region as a whole”.

Newspapers in August 2008 splashed the news: Death of Doha!

It was the announcement of the end of a dream of a world without restrictions on movement of goods across political frontiers and economies without farm subsidies.

It all began in Doha back in 2001, when world leaders gathered under the auspices of World Trade Organisation (WTO), now comprising 153 countries. Since then, they met off and on, holding discussions, known as the Doha rounds of talks.

Steadily they moved over the next seven years towards signing a new global deal for opening markets, cutting farm subsidies and strengthening the international trading system.

It looked close to signing the deal until 28 July in Geneva, after nine days of high level talks. It was thought that soon poor farmers in developing countries would have access to markets in Europe, the US and Japan for their produce and primary goods.

**Favourable time**

Soaring world food prices provided a fine opportunity for rich countries cutting production and export subsidies as their farmers were prospering. It appeared never easier to reduce farm subsidies, one of the most delicate issues in trade talks.

The main issues seemed to be the level of US trade-distorting farm subsidies and the scope of exceptions for developing countries on industrial tariff cuts. So the talks focused on agriculture and industry subsidy and tariff cuts, leaving most other areas until later.

There were three groups of countries involved:

- The United States, which sought assurances that market opening in other areas would compensate them for concessions such as farm subsidy cuts;
• Developing country exporters, which export to developed and other developing countries; and
• Big developing countries such as India, Indonesia and China, which need to protect subsistence farmers from a flood of imports.

The negotiations stumbled on proposals for so-called Special Safeguard Mechanism (SSM) measures. The developing countries led by India wanted to retain the right to protect poor farmers by imposing special tariffs on certain agricultural goods in the event of a sudden import surge or collapse in prices.

They argued that this was necessary to stop their subsistence farmers being overwhelmed by the market opening as agreed in the talks. The first volume trigger for the rise in tariffs was a 10 per cent rise in imports. This led developing country importers such as Uruguay and Costa Rica to say the safeguard would stifle normal trade growth, not just deal with emergencies, and could even shut off existing trade.

Another proposal would allow importers in some circumstances to raise tariffs temporarily if imports grew more than 40 per cent.

None of these conditions were agreed to by the United States.

Collapse of talks

Was the US stalling for time to avoid a rift over another sticking point, cotton subsidies? The US has been subsidising the price of its cotton to the extent of 44 per cent and does not welcome imports of cotton from Africa!

Developing countries were not competing with the US farmers, but only with the US Government, as the negotiating Indian Minister Kamal Nath pleaded.

The US was aware that India would not give ground on SSM, in which case India would be blamed in the case of any collapse.
European Union Trade Commissioner Peter Mandelson said it was ‘heart-breaking’ that efforts collapsed due to one single element.

“Of all the failures they could have tripped up on ... that (the SSM) trade restraint measure and a small gap in numbers managing to provoke this failure is ... absolutely heart breaking,” he told reporters after talks broke down.

The US Presidential elections are scheduled in November. The Democrats are no great enthusiasts of free trade. Recession in the US would only take them deeper into the familiar ways of protecting their jobs on farms and in factories.

Farmers in rich countries are breathing a sigh of relief. The US cotton ranchers, Irish beef farmers, South Korean and Japanese rice growers and French poultry producers were against any talks leading to lower tariffs or subsidies that protect them against competition from poor countries.

**Food security**

Every country strives for food security. Japan has been protecting its rice farmers by high tariffs, as rice is part of Japanese life and culture. It is always outside the list of items in any free trade negotiations with Australia or the US.

The world respects it and lives with it. But when it comes to poor countries, the rich nations take the hard line. In the context of current high fuel and food prices and uncertain economic conditions, each nation strives to achieve some measure of food security and seeks the ability to protect their farming populations in an increasingly volatile world.

In poor countries, agriculture has been the oldest occupation, since the Neolithic revolution. It is still the centre of gravity of livelihoods, culture and social values.

So the Special Safeguard Mechanism (SSM) was the safeguard the developing countries wanted.
Mari Elka Pangestu, the Indonesian trade minister called it “a reasonable request” and said it was blocked by an inflexible US.

Now, we know who killed Doha!

But in the best of traditions, we say: “Doha is dead, but Long Live Doha!”
The Euro is in trouble.

The single currency of the 16-nation Eurozone recorded the steepest fall to date in early February 2010 -- all because of one country: Greece.

It is alleged that Greece has all along suppressed its debt figures. In fact, a more serious allegation was that Greece fudged its statistics right from the days when it was trying to join the elite club, the Eurozone.

It is like a student falsifying his marks transcript to join an institution of higher learning. When the true colours finally come to light, the victim would not be Greece. It would be the Eurozone. That would be a great tragedy.

A Greek tragedy is defined as a drama in which the main character is brought to ruin as a consequence of a tragic flaw, moral weakness, or inability to cope with unfavourable circumstances.

**Eurozone to the rescue**

It has to stand up and protect the member country.

Why? There are great stakes involved: the grand old dream of the visionaries of the last century, Jean Omer Marie Gabriel Monnet and Robert Schuman. Their dream was all about creation of a single economic space with full freedom for capital and labour mobility towards attracting investment and generating jobs, incomes and wealth.

The process was through monetary discipline imposed by a common central bank, with a common currency to reduce transaction costs. That dream cannot be allowed to go wrong!

The euro was to become the world’s other reserve currency, aimed at ending the monopoly of the American dollar. As Germany, the powerhouse of Eurozone was on full steam, the world was looking to the euro as an alternative to gold for saving and investment, in times of inflation and domestic uncertainties.
When the single currency was born on January 1, 1999, with 11 countries (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain), as members of a currency union, Greece was left out but eager to join. Britain, as a member of 27-nation European Union, preferred to stay out. So, too Norway and Sweden.

There are criteria to fulfil. The minimum qualifications for the exclusive club are:

- Inflation: No more than 1.5 percentage points higher than the average of the three best performing (lowest inflation) member states of the EU;
- Annual budget deficit: ratio of the annual budget deficit to gross domestic product must not exceed 3 per cent; and
- Debt: ratio of government debt to GDP must not exceed 60 per cent.

Greece was admitted to the club in 2001, followed by Slovenia in 2007, Cyprus and Malta in 2008 and Slovakia in 2009.

A license to (fiscal) kill!

Joining the euro in 2001, Greece took it as free licence for access to international markets. The Greek government borrowed externally to go on a 10 year spending programme. No doubt, the Greek economy boomed. The public sector expanded and wages doubled. Corruption set in with the expanding civil service. Widespread tax evasion was the end result.

As the global financial downturn hit USA and then Europe, Greece was taken by surprise and was ill-prepared to cope.

It has come to light that Greece’s budget deficit is 12.7 per cent of GDP, more than four times higher than Eurozone rules. Its debt is 300 billion euros ($419 billion) and 125 per cent of GDP.

Knowing well that the future of the whole Eurozone is at risk, the Finance Ministers of the Eurozone gave an ultimatum to Greece to reduce the budget deficit to 8.7 per cent by effecting major cuts in public spending and by new, revenue-increasing measures as a condition for bail-out.
European nations are angry that Greece kept the true size of its deficit hidden through complex financial transactions.

Besides the worries about how Greece would balance its books and avoid defaulting on its external debt and whether IMF would rescue the Eurozone, the greatest worry is the euro itself.

Expulsion of Greece? The European Central Bank President Jean-Claude evaded it: “I don’t comment on absurd speculation.”

**Lessons for Pacific Island Countries**

In 2003, an Australian Senate Committee made a recommendation that Pacific Island Countries (PICs) should eventually adopt the Australian dollar as common currency. Its goal was to bring about monetary discipline as Solomon Islands and others were indulging in monetisation of budget deficits by printing money.

But it is now clear: Although the Eurozone was able to control money and formulate and implement common monetary policies, it could not enforce fiscal discipline, as member governments are outside the control of a common central bank.

So the lesson is that PICs, before entering into currency union with Australia (an ambitious goal under PACER) or forming a bloc amongst themselves (under PICTA), should set their houses in order and maintain fiscal discipline.

Greece dreamed to be a member of an elite club. Poor fiscal discipline has landed both Greece and the Eurozone in the soup!

British comedian Tommy Cooper’s one liner went, “Last night I dreamed I ate a 10-pound marshmallow, and when I woke up the pillow was gone.”
As the saying goes, “Once bitten, twice shy!”

Even if not bitten before, one would learn from the experiences of others.

A draft of a study (the Study) on Strengthening Trans-Tasman Economic Relations, released in mid-September by the Australian and New Zealand (ANZ) Productivity Commission says “No!” to a common currency for the Tasman neighbours!

Obviously, the ongoing Eurozone crisis is responsible for the Study finding.

Economic co-operation between the two countries will soon complete a very successful 30-year period under the Australia New Zealand Closer Economic Relations Trade Agreement (ANCERTA), which came into effect on 1 January 1983. The study commends the benefits of ANZ economic co-operation, which include growth in trade volume and increased mobility of labour and capital. Tariffs and quantitative restrictions have been eliminated on almost all goods and there is free movement of citizens between ANZ. The ANCERTA has also extended into new areas, beyond trade, in services as well.

At the last annual meeting, the prime ministers of ANZ asked their Productivity Commissions to submit a joint report on further areas of co-operation for consideration at the next meeting in 2013.

**New measures**

The Study recommends new measures for further strengthening of economic co-operation. They include (i) dismantling of ‘rules of origin’ for all goods for which tariffs are at 5 percent or less so that compliance and administrative costs for a significant proportion of trans-Tasman trade are eliminated; (ii) reducing transport and telecommunication costs, promoting greater trade volume; and (iii) exploring improvements in three areas: foreign direct investment, taxation and banking.
The Study wants the investment protocol to be extended for lessening remaining ownership restrictions in ‘sensitive’ areas. Further, it suggests companies be allowed imputation credits on trans-Tasman investment so company income is not taxed twice if it crosses the Tasman. Regarding banking, the Study wants a common approach to prudential supervision.

**On Single currency**

On common currency for ANZ, the Study recognizes the likely benefits. These include savings in transaction, since there will be no more currency conversion and exchange rate risks. However, the Study feels there are other costs that would far exceed benefits.

The structures of the two economies are different. The NZ economy is more agricultural, whereas the Aussie economy is a mineral-based export economy with a larger manufacturing sector. The two economies have been experiencing divergent business cycles. If the Kiwi dollar is replaced by another currency - either the Australian dollar or an altogether new currency, such as an ANZAC dollar or Tasman dollar - the dominant economy would be Australian. A common monetary policy would be more geared to the Australian economy.

An anti-inflationary policy, if adopted by the common central bank for fighting inflation in the dominant economy, would not be suitable for the NZ economy, if the latter goes through recession. Secondly, if external shocks affect the two economies in two different ways, the policy response has to be different. For example, a slowdown of the Chinese economy affecting mineral exports of Australia would elicit a response which would be different from the one needed for New Zealand, if the latter is not affected by the shock to the same degree.

Similarity in economic structures and impacts of external shocks is essential for success of common monetary policy, in the event of a single currency and one exchange rate.
A high degree of convergence of the two economies is a critical requirement for a monetary union.

**Single currency for the Region**

If a monetary union has to become successful, it has to be a fiscal union as well. A common fiscal policy will have to evolve over time. That means surrender of political sovereignty as well, besides monetary sovereignty.

Twelve years ago, a former Governor of Reserve Bank of New Zealand, Don Brash told a Rotary Club audience in Auckland that the time for a common currency had not yet arrived, since the pre-conditions of convergence were not yet fulfilled.

The situation continues to remain the same.

In 2003, an Australian Senate Committee proposed the Australian dollar for Pacific island countries (PICs) as a common currency for ensuring greater monetary discipline. However, Professor Phillip Powell of Indiana University argued against it, at a Canberra Conference in 2005, describing PICs as not yet ready for a union.

Apparently, he was recalling a contemporary American television film, in which two 17-year old teenagers thinking they are in love decide to get married, despite their parents disapproval, only to realise soon they have very different views on the future.

The title of the television film was “Too Young to Marry!”
“What’s in a name? That which we call a rose, by any other name would smell as sweet.”

That is what Juliet asked in the celebrated Shakespearian play Romeo and Juliet.

Griffin cream biscuits, though now made in Fiji and eaten in Auckland, are still as yummy as they tasted 140 years ago.

Griffin assured consumers that the recipe did not change.

That was poor comfort, when national pride was already “hurt”, when the Kiwis came to know that Griffin, one of the oldest Kiwi institutions established in 1864, has been outsourcing some of their cream biscuits to Fiji since this month.

Consumers noticed in mid-November the sudden disappearance of the familiar “Buy New Zealand Made” logo from some biscuit packets. These include the famous: Cameo Cremes, Belgian Cremes, Lemon Treats, Melting Moments and Swiss Cremes.

Although Griffin did not identify them, they conceded “some” cream biscuits were now outsourced and that is why the logo was not on those packets.

No doubt, outsourcing takes away some local jobs. Cream biscuits account for about 3 per cent of Griffin’s production.

New Zealand trade unions are unhappy. Outsourcing means loss of jobs to Fiji. Some shed “crocodile tears” that Fiji workers might be exploited and Griffin might be taking advantage of “poor working conditions in Fiji”.

Offshore outsourcing is a decision based on business principles.

Why outsourcing?

One reason is demand had exceeded the Auckland factory’s production
capacity. There are others.

In labour-intensive industries, such as computer software, outsourcing has been going on for quite some time. India and China have comparative advantages because of low wages, quality work and cheap resources.

Management pundits caution that outsourcing and offshoring, although used interchangeably, have important technical differences.

Offshoring is the transfer of an organisational function to another country, regardless of whether the work is outsourced or stays within the same corporation/company. Outsourcing signifies contracting with a supplier, which may or may not involve some degree of offshoring.

Secondly, with increasing globalisation of outsourcing companies, the distinction between outsourcing and offshoring is becoming less clear over time, as witnessed in the growing number of foreign outsourcing companies in the US and UK.

Niceties of technical definitions aside, outsourcing to Fiji by Griffin is good.

**Tariff factories**

Years ago, manufacturing units in a low-cost country opened up production plants in a country with high tariffs for producing for the protected market. Such relocated plants from low-cost country to high-cost country and getting over high tariff walls was called tariff factories.

When tariffs are already low, the shift to Fiji signifies the recognition that Fiji can deliver!

In the 1970s, firms in Japan were seeking low labour cost locations in Asia for foreign direct investment. Matsushita of Japan, famous for electronic appliances such as radios and transistors and TVs under the brand names of National and Panasonic for Asian and North American markets, was attracted by investor-friendly incentives offered by Malaysia. It was a great success.
labour and above all foreign exchange.

Such relocations of production of consumer goods and household appliances, which belong to the lower rung in the technological cycle, from high-cost to low-cost countries, are known as “flying geese pattern of development”.

Fiji, PICTA and PACER

Griffin’s outsourcing is just an indication of future gains from regional integration. The Pacific Island Countries Trade Agreement and Pacific Closer Economic Relations Agreements and Pacific Plan aim at creating a single economic space, free from impediments to trade. If the “concept of an area without frontiers” becomes a reality, there will be more re-locations.

With its comparative advantage in skilled labour, Fiji will produce for New Zealand and Australian manufacturers at less cost and export to other island countries since transportation cost will be lower than otherwise.

Maybe Fiji initially will get lower rung industries with low technological sophistication. But it certainly will prove to be a big leap!

So, what is good for Griffin is also good for Fiji!
All less developed countries want to grow. Yet some of them prefer continuing to be called least developed country (LDC), even if they record impressive increases in their national incomes. They do not want to graduate to the next higher level: a developing country.

Vanuatu government officials were in New York to present their case before the UN Committee for Economic and Social Commission (ECOSOC) to continue as an LDC along with Kiribati (per capita income: $US703 in 2006 prices), Samoa ($US2277), Solomon Islands ($US684).

Vanuatu (per capita income: $US1799) feels it might lose some privileges which are associated with LDC status. These privileges relate to market access for their exports as well as special treatment in many areas include trade and foreign aid.

Benefits of being an LDC

During ministerial talks in Hong Kong, it was agreed LDCs could have 100 per cent duty-free, quota-free access to US markets after the Doha round of trade talks were completed. When the Doha talks collapsed, LDCs do not want to miss any chance and they would like to continue clinging on to current provisions relating to special treatment, particularly in terms of trade and aid to support their development priorities.

The benefits of being in the LDC group include eligibility for the US government sponsored Millennium Challenge Account (MCA) fund. Vanuatu is the only Pacific island country to qualify and received a handsome grant of $US66 million for a host of infrastructure projects such as ports, jetties in the outer islands and rural roads.

Further, LDCs are eligible for soft loans from the World Bank and Asian Development Bank (ADB). The soft loans are generally for a long maturity period ranging from 30 to 40 years with an interest rate varying from 1 percent to 0.75 per cent, referred to as a service charge. Thus, these soft loans have a huge grant element.
Criteria

The cut off level of income to distinguish developed countries from the rest is per capita gross national income, $US11, 456. There are 66 high-income or developed countries and territories; and 185 developing countries and territories. The developing countries are divided into high middle, low middle and low income countries. The LDCs are ranked next to the developing countries.

Among Pacific island countries, Fiji with its current per capital income at $US3306 (2006 prices) is called a low middle income developing country. Consequently, Fiji does not enjoy any special privileges, including the facility of soft loans from the World Bank or ADB.

The least developed countries are categorised on the grounds of three criteria laid down in 2006: (i) per capita income; (ii) the Augmented Physical Quality of Life Index (APQLI); and (iii) an Economic Vulnerability Index (EVI).

The APQLI relates to human resource weakness criterion, involving a composite Human Assets Index (HAI) based on indicators of: (a) nutrition; (b) health; (c) education; and (d) adult literacy.

The EVI is based on indicators of: (a) the instability of agricultural production; (b) the instability of exports of goods and services; (c) the economic importance of nontraditional activities (share of manufacturing and modern services in GDP); (d) merchandise export concentration; and (e) the handicap of economic smallness (as measured through the population in logarithm); and the percentage of population displaced by natural disasters.

The earlier (2003) criteria for categorising developing countries into LDC did not include EVI, but included the following: threshold per capita GDP of $US765; an augmented physical quality of life index of 47; economic classification index of 26; and threshold population of 75 million. The current 2006 requirements for a country to be called an LDC are: a GDP per capita less than $US1035; an EVI score of less than 34; and an APQLI score greater than 64.
LDCs of the world

As of September 2006, there were 50 LDCs as designated by UN Office of the High Representative for the Least Developed Countries. With the graduation of Cape Verde in 2007, there were then 49 countries in the world designated as LDCs on the basis of the 2006 criteria.

Africa has the largest number - 33.

They include Angola, Somalia, Sudan, and Uganda, which often hit the headlines for one reason or another such as civil strife. Asia has 10 LDCs, which include Bangladesh, Bhutan, Maldives, and Nepal. Central and Latin America has only one, which is Haiti. The Oceania region has five LDCs, which are Kiribati, Samoa, Solomon Islands, Tuvalu and Vanuatu.

Every three years, LDCs are reviewed by UN Economic and Social Council’s (ECOSOC) Committee of Development Policy (CDP) for identifying any of them that could eventually graduate because of improvements in any of the three criteria. Based on the CDP report, the ECOSOC makes a recommendation to the UN General Assembly, which is responsible for the final decision on the new list of LDCs for operational purposes.

Ever since LDCs arrived on the scene, there have been only two graduations. The first country to graduate was Botswana in 1994, was followed by Cape Verde. It is obvious why countries in LDC list are not keen to graduate.

Special Case

Special consideration has been shown to Pacific island countries. Except for the Solomon Islands, all PICs have higher threshold incomes.

Their human resource development indicators are far superior to the countries in Asia and Africa. Special considerations include recognition
of PICs’ vulnerability to the extremes of weather conditions, including their location in the cyclone prone regions of the Pacific as well as high earthquake risks.

On the basis of threshold income level, Vanuatu was found eligible for graduation from LDC status in 1997. However, it was allowed to retain the LDC status on the grounds of perceived deterioration in the quality of life following a major earthquake in 2002, which inflicted severe damage on public and private properties in Port Vila. Much before the earthquake of 2002, Vanuatu’s Prime Minister pleaded in his 1997 address to the UN General Assembly for retention of LDC status. The General Assembly in its resolution: 52/210 of 18 December 1997 withheld the recommendation to graduate Vanuatu.

**Review of LDCs**

On the basis of the 2003 triennial review, CDP concluded that Cape Verde, and Maldives and Samoa were eligible for graduation in 2006. Cape Verde graduated, Maldives after the tsunami of 2005 continued in the LDC list and the decision on Samoa was left pending.

Although Vanuatu was not figured in the latest CDP review report, a preemptive move by the government is understandable. A timely lobbying is essential for retaining the LDC status. Vanuatu has done very well among all Pacific island countries with an impressive growth rate at 5 per cent to 6 per cent per annum over three years on a continuous basis. Its per capita income is growing along with improvements in quality of life. A grant of $US66 million gave an additional boost to the country’s development efforts.

The fears of graduation on the basis of good performance and the consequent loss of privileges are understandable. Vanuatu feels that graduation would be less beneficial or even harmful.

Rephrasing Oscar Wilde, one would say: “A little progress is a good thing, and a great deal of it is absolutely fatal.”
The mining sector is now emerging as the new engine of growth in developing economies in all the regions.

The Pacific region is no exception.

Papua New Guinea (PNG) is a leading example, Fiji with its copper, bauxite and manganese minerals in Namosi and Waisoi areas is the next to join the list.

The Revenue Watch Institute (RWI), a non-profit organisation striving for effective accountable management of oil, gas and mineral resources in its report of May 15, says 32 out of 58 countries that rely on mineral revenues did not meet “basic standards of resource governance”. These countries produce 85 percent of the world’s oil and 80 percent of copper.

The RWI calls for full public disclosure of contracts between governments and extracting companies and greater transparency on revenues.

PNG is increasingly getting aware of the need for the wise use of natural resources and equal distribution of wealth to all. There are new policy initiatives. These include downstream processing, mine waste management, mine closure, sustainable development, study into state equity options, state fiscal provision, royalty options and compensation rate review and dispute resolution.

Its mining sector contributes 57 percent of PNG’s country’s export revenue for the last 15 years. It is the largest contributor to the economy since 1967. While agriculture contributes 23 percent of the country’s export earnings, minerals contribute more: crude oil: 15 percent, copper: 19 percent and gold: 37 percent.

The mining industry and its contributions to economic growth, in developed and developing economies and the role of mining and future implications for Fiji are the focus of attention in different forums.
FNU Conference paper

On May 8, Fiji National University (FNU) opened its three-day Conference on Finance and Investment in Fiji with an important paper on Australia’s mining experiences and neglect of its own non-mining sector. There are important lessons for Fiji.

Mr. Raj Prasad in his paper pointed out the failure by successive governments in Australia to promote value-added manufacturing activities. Australia, which was the biggest supplier of coal, iron ore and natural gas to China, failed to establish processing industries.

Mr. Prasad gave an example: The 20- litre oil drums are made from Australian iron ore, which are processed in China; the metal is then shipped to Singapore and pressed in drums; and empty drums were shipped to Australia for the food industry.

That was responsible for the shrinking of their manufacturing base and loss of technology, aside from environmental degradation caused by uncontrolled mining activities.

Mr. Prasad had a piece of advice for policy makers of Fiji:

- Build a rigorous legislative framework;
- Draw on global experience to frame proper legislation; and
- Ensure the existence of a framework before issuing licences.

The multinationals would respect sitting legislations rather than new impositions. Since Fiji wants to develop its mining sector, the country should develop the ability to counter-balance the might of multinationals. It should implement an effective resources rent tax. Mr. Prasad called for hiring an independent panel of mining experts for preparing and reviewing financial feasibility to provide guidance on environmental protection. He wanted the establishment of a supervising and monitoring unit for observance of proper accounting procedures with built-in criminal and civil penalty provisions for non-compliance.
**The African case**

Same concerns in regard to mining were expressed by a report released in Africa just about the same time. On May 10, a panel chaired by the former UN Secretary General Kofi Annan called for end to ‘unconscionable’ exploitation of Africa’s mineral resources.

Other members included Sir Bob Geldof, the chief executive of the Prudential, Mr. Tidjane Thiam and Ms. Linah Mohohlo, Governor of Botswana’s central bank.

The Report is an annual feature, known as the Africa Progress Report. The 2013 Report said how the economic benefits of extracting natural resources such as oil and iron ore often fail to flow through to the local population.

Mr. Annan writes in his foreword to the Report: “Africa loses twice as much in illicit financial outflows as it receives in international aid”.

Mr. Annan says some companies, often supported by dishonest officials, are using unethical tax avoidance, transfer pricing and anonymous company ownership to maximise their profits, while millions of Africans go without adequate nutrition, health and education.

A number of resource-rich African states including Equatorial Guinea and Angola recorded high economic growth rates in recent years due to mining activities, but little trickled down. There is widening inequality. The Report emphasises that industrialised countries should “enforce corporate transparency for making it clear to Africans who owns the companies involved in mining deals”.

Mr Annan wants “a crackdown on the international tax rules that allow
multinationals to shift profits from one country to another with impunity”.

**Strengthening capacity**

The Report stresses the need for African governments improving their governance and strengthening national capacity to manage their mineral industries.

Putting transparency and accountability at the heart of their natural resource policies will ensure and secure a fair share of natural resource revenue for their citizens for spreading benefits of revenue via equitable public spending.

While launching the Report, Botswana’s central bank governor Moholo stressed that African governments should own at least a 50 percent stake in any new mining venture in order to ensure the country receives more of the revenue that flows from a project than the mining company receives.

Further, the governor made it clear that central banks should handle the revenue flows from mining. “The country, or the government, must receive more of the revenue flows out of a project than the company does”. Further, there should be definite dates ending the tax holidays often granted for a project to start.

Governor Moholo declared:

“The state’s role is far greater than just being a partner that extracts profits and collects taxes”.

As Argentina’s soccer hero Lionel Messi sent his fellow countrymen into rapturous heights during the World Cup 2014 matches in mid June, an American Supreme Court’s decision plunged the country into the abysmal depths of a debt crisis.

On June 17, 2014, a US Supreme Court judge rejected Argentina’s appeal against a lower court decision and ordered payment of US$1.3 billion, the full value of bonds to US-based creditors. The decision was the culmination of a ten-year legal battle against the “hold-out creditors”, who rejected the re-structuring terms and conditions of the defaulted loan repayment in 2002.

Argentina’s President Cristina Fernandez de Kirchner described the creditors as vultures. She however had to put up a brave show as Argentina was marching from one victory to another in Brazil. She announced that she would not negotiate with the hold-out creditors wanting their full pound of flesh.

A worried IMF

Everyone, however, was aware of a likely major disaster, waiting to happen. If the court order is carried through, Argentina will have no funds to meet the June 30 installment due to be paid to those who had accepted restructuring terms.

The International Monetary Fund (IMF) is worried that failure to honour the US legal order would have “broader systemic implications”. The IMF concern is the US Supreme Court decision would act as a precedent and it would encourage more US creditors to hold out in future restructurings of any sovereign debt. The IMF has been involved in similar restructuring of loans to countries which are currently in trouble.

Promptly, Standard and Poor’s (S&P) cut the Argentina’s credit rating by two notches from “CCC+” to “CCC-”. Already, Argentina is unable to raise funds on the international market since its 2001-02 debt default.
The rating agency’s latest cut is the unkindest cut of all: the “limited capacity to pay the plaintiff creditors while servicing its current debt”.

**No stranger to debt crisis**

Argentina, South America’s third-largest economy (population: 41 million; GDP: US$484.6 billion; and GDP per capita US$18,608), has the dubious distinction of committing the biggest debt default in world history.

Argentina had a checkered past with dictatorships and democracy alternating during the last century. Although some order was restored in the late 1990s, persistent excessive fiscal spending, inflation, capital outflows and corruption contributed to unprecedented growth in public debt, most of which was held by foreigners. The IMF helped to rescue the economy with loans. As Argentina failed to service the debt, IMF extended payment schedules as well.

The crisis intensified when the IMF refused in late December 2001 to release part of a loan, citing Argentina’s failure to reach previously agreed-upon budget deficit targets. Argentina faced the biggest default of all times: US$100 billion. External debt reached its peak: 143 percent of GDP.

Restructuring of defaulted loans took place to save Argentina from disaster. About 8 percent of the US-based creditors/hedge funds refused to accept the terms. The other 92 percent holding the defaulted debt agreed to write off two-thirds of their pre-crisis value. The write-off gave breathing time to Argentina.

Thanks to farm exports of wheat and soya beans in the next few years, Argentina paid back US$150 billion to its creditors. The debt level fell to 40 percent of GDP.

**Pacific situation**

Among Pacific island countries (PICs), Marshall Islands (external debt: 120 percent of GDP) has been graded as “high risk” by multilateral lending
agencies including Asian Development Bank (ADB). Two PICs are rated as medium risk: Samoa (66 percent) and Tonga (41 percent). None of the PICs except Fiji is exposed in any significant degree to overseas private sector creditors.

Fiji’s external debt level is less than 20 percent of GDP. It is not eligible for concessional loans from World Bank and ADB. Due to increasing exposure to overseas private sector loans, ratio of multilateral loans to external debt declined: from 47 percent in 2005 to 18.4 percent in 2012.

For avoiding loans with conditionalities from IMF and ADB, Fiji resorted to issuing international bonds: first in 2006 for US$150 million and the second in 2011 for US$250 million. The overseas private sector institutions are dominant creditors. After fully meeting its obligations for the first bond issue, Fiji is currently meeting the interest obligations for the second one.

On June 28, Argentina asked the US judge to issue a stay of his ruling against the country as it seeks to negotiate the hedge funds. That is the only way out.

The lesson for PICs is clear. Borrowing in the international market is not free from risks. All private lenders, overseas or domestic, are motivated by greed.
“Believe it or not!”, as Ripley would challenge, people are fascinated by crazy ideas.

Americans never run out of ideas!

In February, America would hit the debt ceiling of US$ 16.4 trillion laid down by the US legislature.

The Republicans who lost out the battle against President Obama’s efforts to avoid the fiscal cliff are now readying for another round.

So, there is a bizarre, maybe a Democrat idea: mint a trillion-dollar platinum coin to circumvent the debt ceiling.

The idea reminds us of a delightful story by Mark Twain, which was made into a memorable movie by Sir Arthur Rank Production, starring Gregory Peck.

The story goes thus: A penniless Henry gets a million pound note as a gift from two rich brothers, Oliver and Roderick. Henry is unable spend it since no ordinary person would be able to change it. He is also not able to change that note in the bank. On the contrary, he is charged with theft and arrested.

Without knowing, Henry is actually the subject of a bet between Oliver and Roderick: Oliver says a mere possession of a symbol of wealth will enable anyone to have anything he wants, without actually cashing the note. Roderick, on the other hand, feels that the prohibition against exchanging the note for cash will render it totally useless.

Crazy, but clever?

The US law permits the government treasury to mint any coin and give a value, say one trillion. It can then be deposited at the Federal Reserve (the Fed). In turn, the Fed can transfer one trillion bucks to the government for salary payments to its employees, in case it runs out of money in February. There is a public petition going around with a required minimum number
of 25,000 signatures for minting the one trillion dollar coin.

The petition makes it clear that it wants to avert the debt ceiling struggle in Congress. The last face-off was in July 2011. It brought down the credit rating of America, followed by a world-wide financial market earthquake.

The petition, which wants to avoid a recurrence, states: “While this may seem like an unnecessarily extreme measure, it is no more absurd than playing political football with the economy.”

The Republicans acted fast: One Congressman, Greg Walden hinted that it would introduce a bill to ban government from creating high-value coins to pay its debts.

The idea of minting a platinum coin is political. It is to neutralise the Republican threat that federal employees would not be paid.

If a crazy idea is supported by a Nobel Laureate, Paul Krugman, it attracts attention. Similar to the maxim, a lie if repeated 1000 times becomes gospel truth. That was in the olden days.

In modern days, in a media free country, stand-up comedians such as Jon Stewart enjoy being “economic experts”. They tore the minting idea to pieces.

Jon Stewart joked:

“I say go big or go home- it makes just as much sense to mint a twenty-trillion dollar coin or maybe just ‘find’ a ‘one-hundred quillion-dollar bill’, featuring a centaur and a unicorn, as it does to make the trillion-dollar coin.”

Funny economists are only embarrassing. If comedians become economists, it is more worrisome!

The impact was quick. The idea was promptly given up.
A Treasury spokesman quietly announced: “Neither the Treasury Department nor the Federal Reserve believes that the law can or should be used to facilitate the production of platinum coins for the purpose of avoiding an increase in the debt limit.”

The legislature and executive wings have to work out a practical solution.

Lessons

The episode has lessons for students of monetary economics.

Conservatives fear that government abuses its sovereign power by printing money. The currency is debased by reducing its value, if money supply is increased to fund deficits. However, no government collapses.

The early 20th century German hyper inflation is always fresh in memory. The Fed has a successful experience over fighting inflation in the post-war world.

**The latest fear is only from deflation, not inflation!**

Further, America is not Greece. It has its own currency with a central bank; and its debt is not in euros. Government can monetise its debt by borrowing from the Fed. The government cannot default. However, how far a central bank would cooperate depends upon its own assessment and the degree of independence it enjoys.

In a free country, no government can make heavy inroads into central bank autonomy.

Finally, money issued by modern governments is fiat or paper money. Money is created simply out of thin air.

Chris Hayes, the American TV host aptly described money as “nothing more than a shared illusion”.

The society accepts it as medium of exchange only on trust. Otherwise we will have a barter economy, which necessitates fulfillment of conditions of double coincidence of wants.

With all its advantages of money, Chris Hayes reminds us:

“The genius of the trillion-dollar coin is that it illustrates the uncomfortable foundational reality of modern capitalism.”
At the Second Annual Fiji Business Forum held in June 2014, the President of the Suva Chamber of Commerce and Industry called for solidarity amongst its members to promote investment for boosting economic growth, by refraining from “constantly pulling each other down”. Dr Nur Bano Ali warned against negative stories flying around, saying they only render access to finance difficult.

That is exactly what is happening in the world economy.

Fear of the euro zone failure

Although President Mario Draghi of European Central Bank (ECB) assured the world that he would do “whatever it takes to save the single currency”, his hands are tied. European Treaty rules forbid ECB from financing governments. Jens Weidmann of the Bundesbank, central bank of Germany is opposed to ECB action of purchasing sovereign debt. ECB has never antagonised Bundesbank, as its approval is critical for German tax payers’ support for the euro zone. Hopes for a quick solution are elusive.

In a report on August 3, IMF warns about the spillover effects of inaction in the euro zone. If euro zone fails, it would cost Europe more than 5% of economic output. Britain would also fare almost as badly, the US could lose 2% of output and Japan could shrink by more than 1%. The contagion would spread to China and then Australia, major exporter of minerals and eventually to our region.

Stalemate in America

In an election year in America, two candidates for the world’s most powerful office have diametrically opposite approaches to the common goal: creation of jobs and growth. The percentage of unemployment remains high, at 8.3%. It is estimated that at least 250,000 jobs must be created each month, as 12.8 million Americans are still unemployed. In July, only 163,000 jobs were created.

Republican contender, a successful businessman-billionaire himself, Mitt Romney, claims President Obama has no business experience. He asserts
the policies of fiscal stimulus have failed and taxes on higher income groups would hurt investment and discourage innovative job creating business ventures.

Obama argues that economic growth would not just occur because of a few wealthy risk-takers with risky ideas. He says growth needs a supportive environment with appropriate legal measures, public sector provision of physical infrastructure, investments in education, a prosperous middle class and consumer confidence.

On July 13, in a speech in Roanoke, Virginia, President Obama said:

“If you were successful, somebody along the line gave you some help. There was a great teacher somewhere in your life. Somebody helped to create this unbelievable American system that we have that allowed you to thrive. Somebody invested in roads and bridges. If you’ve got a business – you didn’t build that. Somebody else made that happen. Internet didn’t get invented on its own. Government research created the Internet so that all the companies could make money off the Internet.”

Republicans pounced on those words: “You didn’t build that. Somebody else made that happen”- words to remind the electorate that Governor Romney’s immense wealth was mostly inherited and he did not work for it!

The negative campaign continues. One ad says the annual maintenance expenditure on Mrs. Romney’s race horse is US$77,000, which is higher than the US average per capita annual income of US$48,442.

The ongoing battle between the two parties is turning ugly.

The latest is about Governor Romney’s unwillingness to release tax returns of earlier years, giving more ammunition to Democrats.

**Fiscal Cliff**

The US Congress is deeply divided. It has to decide: either let current policy
be effective from January 1, 2013 – which features a number of tax increases and spending cuts, affecting growth and driving US back into a recession – or cancel some or all of the scheduled tax increases and spending cuts, which would add to the deficit.

The highly partisan nature of the political environment renders a compromise difficult. Republicans are keen on spending cuts and no rise in taxes. Democrats are for a combination of spending cuts and tax increases, mostly on the rich.

**Working together**

President Obama’s message is this:

“The point is that when we succeed, we succeed because of our individual initiative, but also because we do things together.”

Mark Trumbul, inspired by an African saying wrote in Christian Science Monitor on 2 August, “It takes an economy to create jobs”.

Not only the entrepreneurs, but other economic agents as well: financial institutions, farmers, factory workers, middlemen and, of course the three agencies, government, legislature and legal machinery. The whole national economy has to work together. That applies to global economic prosperity as well.

The saying also inspired a former first lady of America to give a similar title to her book, a 1996 New York Times best seller. Hillary Rodham Clinton, in her 1996 speech, while campaigning for President Bill Clinton said:

“I chose that old African proverb to title: It Takes a Village and other Lessons Children Teach Us, for my book because it offers a timeless reminder that children will thrive only if the whole of society cares enough to provide for them”.

It needs a global village to create world economic upturn!
It was a week end in July 2008 at the Los Angeles Airport.

Flipping through my passport and finding my valid work permit, the lady at the Continental Airlines check-in counter was curious to know the subject I am teaching. Smugly, I replied, ‘Economics.’

The reaction was swift: “Yuck!”

I was stunned and speechless. Realising my discomfort, she tried to reassure me: “Never mind” and then went about her work this time at great speed.

Without any further exchange of words, she issued the boarding pass and baggage tags. I was left with wounded feelings from that reception at the check-in-counter and quietly wondered; “Is the profession of economist becoming less acceptable?”

I recalled the aspirations of Lord Keynes, who revolutionised economic thinking in the 1930s. He wrote that economists would soon be thought of “as humble, competent people, on a level with dentists”.

What happened since then? Have they become arrogant and incompetent, to be despised by common citizenry?

‘Unusual uncertainty’

No wonder the events of the previous week, some telecast live and some talk shows repeated once in four hours on television, splashed through my mind as I went through the security check. The United States Federal Reserve chairman Ben Bernanke appeared before the US Congress for his bi-annual testimony and painted a bleaker picture than before. In his statement to the House Financial Services Committee, he described the current situation as one of “unusual uncertainty”.

As usual, the stocks plunged on his utterances. Americans are now attuned to listening increasingly to more and more pessimistic analysis on the US economy.
By introducing a new phrase, ‘unusual uncertainty’, he meant only that the data on jobs was weak and uninspiring and the private sector could not create the much expected 100,000 jobs, a level needed to keep pace with population growth and rise in labour force.

Uncertain, because the Keynesian remedy of fiscal stimulus of US$787 billion approved by President Barack Obama last year has not yielded the results.

Need for more stimulus?

In the meantime, President Obama extended unemployment benefits to the jobless for an additional six months: the bill is US$34 billion. How to raise it: another round of public borrowings for financing the budget deficit?

The fiscal deficit stands at one trillion dollars and the Federal debt is US$13.2 trillion, about 60 per cent of the country’s yearly output.

Added to this, the conservative media machinery, led by Fox News TV channel, has mounted a vigorous campaign against the Obama administration.

Citing the failure of the fiscal stimulus and mounting debt, they are dubbing Obama a “socialist”, an ugly word in American party-politics, who would lead America down the Road to Serfdom, the title of a famous book by Freidrich Hayek who waged a war against the totalitarian, socialist states.

The US political scene is now politically polarised, allowing the emergence of fiscal conservatism.

The tax cuts introduced by President Bush in 2007 are coming to an end. If continued beyond December 2010, it will add another US$2 billion to the current fiscal deficit of US$1 trillion. Any talk of further stimulus does not carry any conviction.

So as indicated by Bernanke, who is also known as “Helicopter Ben” for his recipe for fighting depression through government spending, the Fed would
be ready to ease its monetary stance for growth. The markets received the news with scepticism.

**European Scene**

The European Central Bank (ECB) President Jean-Claude Trichet, encouraged by signs of recovery in Europe, is against any more stimuli. In his 23 July article in the Financial Times of London, he described the fiscal stimulus call as oversimplified under the motto: stimulate, activate and spend. As there was little room for some countries, public spending led to rise in debt.

It was estimated public debt would rise in Europe by 20 percentage points during 2007-2011 and in the US by 35 and in Japan by 45 percentage points.

So Trichet’s call is: No more stimuli but only tightening!

**Asian scene**

Asian economies, especially China and India, are uncomfortable with the notion of any tightening in industrialised economies. In Toronto at the G20 Meeting, Indian Prime Minister Manmohan Singh cautioned against any premature withdrawal from fiscal stimulus. His concern is understandable: exports from poor countries to the West will decline and Asia’s growth prospects would be severely affected. So where do the economists stand?

**Models to rescue?**

Given the magnitude of annual budget deficits and ballooning of outstanding public debt in industrialised countries, Europe central bank President Trichet ruled out the application of standard linear economic models, which are used to forecast the impact of fiscal stimuli or fiscal restraint.

Declaring the economic models as unreliable, he observed that in extraordinary times, the economies are close to a non-linear phenomenon of rapid deterioration of confidence amongst households and enterprises,
and savers and investors.

In such circumstances of uncertainty when confidence is at stake, Trichet stressed the need for fiscal consolidation. No econometric models to resort to!

**Nearer home**

Addressing the economists gathered at the recent Fiji Update, Fiji Reserve Bank Deputy Governor Barry Whiteside recalled the old saying: put a number of economists in the same room and we will all have differing views! Why? Nothing is certain in uncertain times: more views are better than the already known views.

Secretary of Defence Rumsfeld under the President Bush administration won a “Foot in Mouth” award by the British Plain English Campaign in 2003 for “nonsensical remarks by a public figure”, when fighting terrorism.

“As we know, there are known things we know that we know. We also know there are known unknowns; things we know that we do not know. But there are also unknown unknowns, the ones we don’t know that we don’t know”.

They are not nonsensical any more.

Now, after the famous unknown unknowns, we have another phrase added to economic lexicon by Ben Bernanke, the world’s most powerful central bank chairman: “unusually uncertain times”.

As I took my seat in the plane for the flight to Nadi, I returned to the question: why economists have not lived up to the expectations of Keynes: “becoming competent people, on a level with dentists”.

Fortunately, as I looked through the delightful piece in the Letters to the Editor of the Financial Times, I got the answer.
Greg Parston of London wrote:

“Since then, fluoridation, better oral health and tooth sealants have contributed to reductions in the demand for, and the supply of dentists. Can we hope for similar preventive breakthroughs in economics?”