Exchange rate and financial management:
some lessons for and from Fiji

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This paper presents three findings. First, the January 1998 devaluation of 20 per cent of the Fiji dollar was long overdue and the result of financial mismanagement over the medium term—the crisis in East Asia was fortuitous in terms of timing of the devaluations. Second, devaluations can only be used sparingly; too frequent a use of this tool can render it ineffective and have serious side-effects on output and growth. Third, a policy package including the float of the Fiji dollar is necessary to get the economy on a sustainable growth path.

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The recent crisis in East Asia has taught the need for prudential supervision of the banking sector; a lesson worth noting in Fiji given the several recent scandals involving large sums of public funds. Financial capital does not pay much respect to fiscal jurisdictions and geographic boundaries; much of the mobility of international capital is due to sharp declines in communication costs and consequently there is a ready availability of information for arbitrage opportunities across both space and time. Capital controls can have some effect in reducing the volatility of capital flows, but they are effective mostly at the margin and only over short periods of time; policymakers will have to adapt to mobile capital and use such mobility to the national advantage.[1] In this regard, it is worth accepting that resources spent on controlling capital flows are wasted except in the short term and over small margins. The Fijian experience with the imposition of stringent capital controls to contain capital flight after the first military coup of 1987 is informative in this regard since anecdotal evidence suggests that these controls were ineffective; some would argue that only the 30 per cent devaluation was effective in reducing short-term capital flight.

With increased exposure to global financial markets, small countries[2] like Fiji have a strong disciplining force imposed upon them in respect of their management of the domestic economy. In the absence of the integration of global capital markets, an economy can tolerate significant mismanagement of its financial sector. In an open capital market, loss of financial discipline will be reflected quickly in the deterioration of the foreign-reserve position, a rise in the cost of capital to domestic agents, and a loss in the value of the domestic currency. Deterioration in any one or a combination of the above will have a deleterious impact on economic activity; the price for which would then be borne by the nation at large.

The most pertinent part of the disciplining effect of integrated global capital markets is the rapidity with which they react. The East Asian contagion spreading from Thailand to South Korea, Malaysia, and finally to Indonesia is a stark reminder of this phenomenon. Even Fiji devalued its dollar on the premise of a backlash in the form of falls in tourist and export revenues, though the evidence presented later suggests that the devaluation was long overdue and the authorities simply took advantage of the events in East Asia for the long-awaited move. It is well known that financial markets tend to over react. The analytical literature has encapsulated this in the form of over-shooting models (Dornbusch 1976). The threat of such over-reaction to mismanagement of the financial sector is generally sufficient to keep the informed from abuse.

Policymakers in Fiji have displayed extreme disregard for the discipline of capital markets, and the penalties for their actions are being borne by the nation at large. Policies and institutions should be implemented to ensure a more responsible attitude towards economic policymaking. Transparency has to be a key component of any strategy that forces those in authority to act in the interests of the nation at large.

The pivotal role of the financial sector in growth

An efficient financial sector makes available to economic agents a variety of financial instruments that enable these agents to pool, price and exchange risk. An efficient financial sector in the presence of open trade enhances the efficient use of resources and encourages savings and business activity, the basis of the growth process in any market-based economy (World Bank 1990). Use of subsidised credit has been prevalent in Fiji (Luckett 1987) and has undermined the development of an efficient and healthy financial sector. Controls on the interest rates not only create a need for discretionary credit allocation due to excess demand but also act as a savings disincentive.

Many developing economies have domestic banks that are supposed to assist in the development of the financial base of the country. But contrary to the good intentions behind the creation of these institutions, their performance has been less than exemplary. Like their other statutory counterparts, they have been a drain on the budget in circumstances when their private sector counterparts have thrived.[3] Many of these national banks are lenders to government-determined priority areas, including to other statutory enterprises. The common story of the taxpayer propping up insolvent government-sponsored commercial banks which in turn support financially non-viable statutory enterprises is often repeated in developing economies (World Bank 1990).

The recent experiences of the National Bank of Fiji, Fiji National Provident Fund, and the Housing Authority, to name a few, are recent cases that mirror the above

phenomenon. Government insuring the viability of public enterprises and incurring the associated 'moral hazard problem' is a trap that should be avoided, even when the short-term costs of doing so are high. Moreover, when nepotism and corruption intrude into the allocation of credit, as alleged in the National Bank saga of 1996 (Siwatibau 1996), then there is a distinct possibility of a total collapse of the financial system. Bailout by the taxpayer, as in the case of the National Bank of Fiji, is justified but reaching such a position highlights deficiencies in forewarning.

The government does have a role in the development of an efficient financial sector. The maintenance of macroeconomic stability, adherence to fiscal conservatism such that the government sector does not crowd out the private sector in competition over investable funds, and support for the smooth functioning of legal and accounting systems creates the environment conducive for the development of an efficient and mature financial base. An open policy

towards foreign direct investment, including minimal policy barriers to entry into the financial sector will create the competition necessary for efficiency. Central banks have an important role, especially in bank supervision, given their responsibility for monetary management.

Public infrastructure in the form of secure property rights, a transparent taxation system, and prudential supervision of banks are necessary for smooth operation of markets. Fiji has most of these. The Reserve Bank Act makes explicit prudential management responsibilities of the banking sector. It is therefore alarming that the taxpayer had to bail out the National Bank of Fiji from insolvency, suggesting the failure of the Reserve Bank in meeting its statutory obligations. The reasons for this failure have to be investigated and remedies put in place to minimise the risks of a repeat of such events. Those found guilty of abuse of office and failure to meet their statutory obligations have to be sanctioned to deter
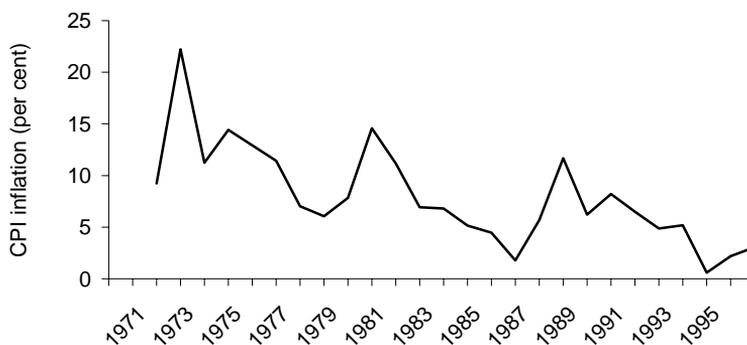
Figure 1   Fiji: exchange rate, 1997–98
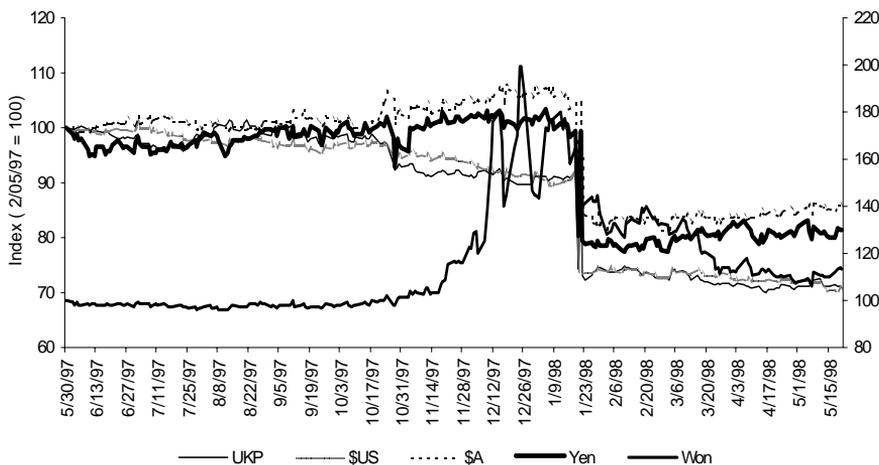
Notes: The RHS axis is for the Korean won, the LHS axis applies to the rest of the currencies.
Source: Datastream, values current as of 21/05/98.

Figure 2   **Fiji: CPI inflation, 1971–97** (per cent)

others contemplating such actions in the future.

The exchange rate and/or the international reserves position are indicators of the health of the domestic financial sector. Exchange rate management in this context becomes an important consideration.

Exchange rate management

Fiji has seen a smooth transition from use of the British pound to a currency board arrangement at independence followed by a trade-weighted peg. Over the last decade, the Fiji dollar has depreciated against the US dollar but appreciated significantly against the Australian dollar (Figure 1). The economy has experienced sluggish growth for the bulk of its two and half decades of independence (see the survey article in this issue).

The two post-coup devaluations in 1987 were forced on the economy to stem capital flight. The immediate consequence of these devaluations was a jump in inflation (Figure 2), despite a wage freeze and price controls. Demand was contracting as the result of uncertainties brought about by the political turmoil; the economy was then in freefall. In contrast, the devaluation of 20 per cent of January 1998 was undertaken in a different environment; a democratically elected government is in place; labour unions are no longer muzzled by political decree; and wages and prices are flexible (at least upwards). It would, therefore, be reasonable to assume that exchange rate pass-through this time would be at least 50 per cent and potentially complete implying a double digit inflation figure for 1998. However, unless the economy is made flexible enough to react to price incentives and bottlenecks in skill shortages are resolved, the supply response from the devaluation will be minimal and eventually prices will rise sufficiently to leave the real exchange rate at its pre-devaluation level.

Though no economy can be completely immune from a financial crisis of the magnitude experienced in East Asia, the necessity for a devaluation was evident

long before the crisis. The stock of money (M2) as a multiple of foreign reserves had been growing rapidly over the last five years; since 1994, the level of this ratio has been much higher than in 1987. The spike in 1987 shows that capital flight was rampant in 1987, but this was brought under control within the year; capital controls together with a 33 per cent devaluation were effective, at least in the short term (Figure 3). But by 1992, this ratio had returned to the peak of 1987. The reasons for this behaviour are canvassed below.

The period after independence is divided into that prior to the coups of 1987 and the period after 1987. The coups of 1987 involved a change in policy stance with an overhaul of senior technocrats in government; the coup year is left out due to the extent of uncertainty during this period.

Inflation and the growth rate of GDP were higher in the first period relative to the second, while money supply growth rate was higher in the second period relative to that in the first period (Table 1). It is important to investigate the reasons for the rapid growth in money supply, particularly when GDP was not showing similar growth rates and the monetary authorities were not following any mechanical rules in determining the level of money supply. The simple quantity theory of money would suggest that the difference in the growth of money supply and growth of GDP would be reflected in inflation; however, this accounting relationship does not appear to hold in the case of Fiji, as shown below. Let the quantity theory be represented as
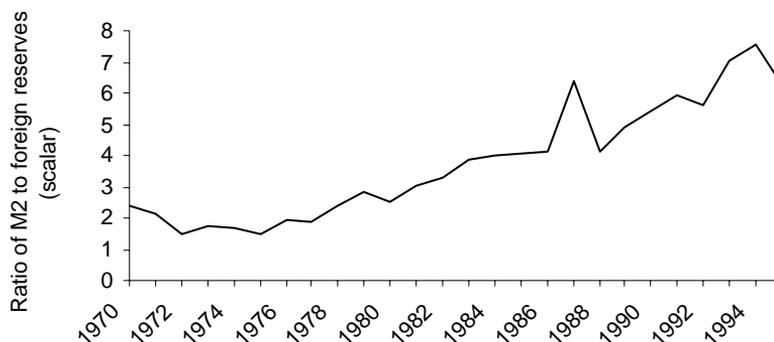
$$MV = PY \tag{1}$$

where M is money supply, V is velocity of circulation, P is the price level and Y is real output. Differentiating equation (1) and rearrangement gives

$$m - y = \pi \tag{2}$$

where small letters denote growth rate of the respective variables expressed in capital letters, π denotes the inflation rate, and velocity is assumed to be constant.[4] The data in Table 1 suggest that the identity in Equation 2 does not hold. Two possible explanations for this anomaly are

Figure 3   **Fiji: ratio of money supply (M2) to foreign reserves, 1970–96**

Table 1   **Fiji growth in output, prices, and money supply, 1970–97** (per cent)

	1970–86	1988–97
GDP (constant prices)	3.9	2.3
Inflation (CPI)	9.4	4.1
Wage rates	10.9	3.1
Money supply (M2)[a]	14.1	17.3
Implied $\hat{\alpha}$	0.8	10.9
Reserves (US$)	7.4	8.7

[a] figures available until 1995 only.
Note: $\hat{\alpha}$ is the difference between the growth rate of money supply (M2) and growth rate of nominal GDP; the usefulness of this estimate is explained in the text.
Sources: International Monetary Fund, *International Financial Statistics*, Washington, DC; International Economic Databank, The Australian National University, Canberra.

first, the difference is the result of the monetisation of the economy, a possibility given that Fiji has lagged behind economies like Mauritius in the extent of monetisation (see Chand and Falvey 1996); and second, there could be hoarding of cash. The former is irrational when the value of the currency is on the decline but legitimate in a climate of political uncertainty. Suppose the monetised economy is a fraction α of the total economy, that is,

$$Y = \alpha Y^* \quad , 0 < \alpha < 1 \qquad (3)$$

then substituting Equation 3 into Equation 2 gives

$$m - y = \pi + \hat{\alpha} \qquad (4)$$

where a circumflex denotes proportional change in the variable. The implied value of the rate of monetisation of the economy at 0.8 per cent per annum in the first period followed by a jump to 10.9 is not plausible; the rate of monetisation is expected to decline over time as a greater fraction of the economy enters the monetary sector. Hence the rapid rise in money supply as a proportion of reserves cannot be attributed to monetisation of the economy.

The growth in the budget deficits and the financing of these deficits provides a better explanation. The rising deficits have been the result of fiscal imbalance; the revenue raising arms of the public sector have been inefficient and expenditure blow-outs have been brought about by frequent bailing-out of public corporations. Central to many of these problems has been financial mismanagement. Scandals in the National Bank of Fiji and the Customs Department, and allegations of the same in several other departments have been a drain on the budget. When perpetrators get away with such criminal acts, there is an increasing rate of such activity. The most worrying aspect of this disturbing trend is the unknown; that is, how much corruption and mismanagement within the public sector is yet to surface. The demand for money rises with an increase in corrupt practices, most of which takes place in cash. Another change post-1987 has been the rapid rise in property prices in urban Fiji, Suva in particular. The bulk of this price effect is not reflected in the consumer price index but funding of such purchases, including through subsidised loans by the

Figure 4   **Foreign debt as a ratio of reserves, 1970–96**
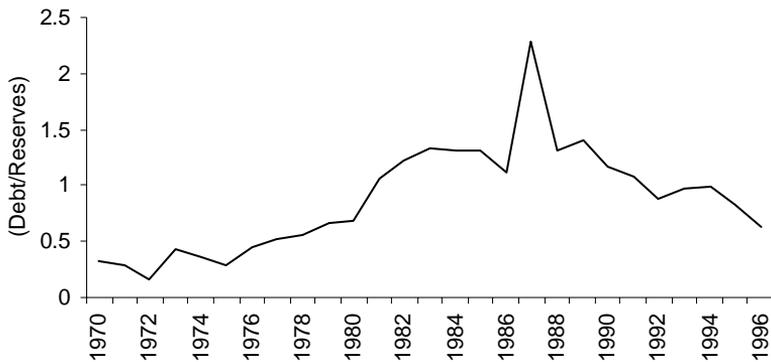
National Bank of Fiji, would raise M2. This rapid rise in M2 without a consequent rise in real activity should be of concern to policymakers.

The one positive indicator amongst the financial variables is the debt-to-reserves ratio. As Figure 4 shows, this ratio has remained modest and definitely not shown a rising time path as a result of the government retiring its foreign debt with excess liquidity in the domestic system. Given the flat economy, this is appropriate, but the lack of demand for capital suggests a poor investment climate. The decline in both savings and investment are symptoms of a sick economy.

The sustainability of a pegged currency can be gauged by observing the time path of the quantity of reserves held per unit of domestic currency. The data in Figure 3 shows that the Fiji dollar was being backed by a declining quantity of reserves over time, the ratio was around two from 1970 to 1980 and then climbed rapidly after 1988 to a peak of 11 in 1995. Such a steep time trend is proof that a given peg is not

sustainable; serious corrections in the peg are inevitable. A similar conclusion becomes obvious when domestic interest rates are considered.

Government bonds are accepted as the most secure form of investment while short-term inter-bank lending rates reflect the liquidity of the market. It is accepted that the T-bill rate reflects the opportunity cost of holding funds. A short-term rate below the T-bill rate indicates that the benefits of holding short-term liquidity outweigh the opportunity costs.[5] This would be the case when there is an expectation that interest rates, or country-specific risks of holding domestic currency denominated deposits, will rise in the immediate term. The T-bill rate above the inter-bank lending rate between 1988 and 1993 is indicative of attempts by the Reserve Bank of Fiji to mop up excess liquidity in the banking system; the interest rate gap suggests that country risks then were significant. The pattern returns to normal after 1993 and until mid-1995 when the inter-bank lending rate fell below

the T-bill rate (Figure 5). This clearly indicates that confidence in the domestic currency had been lost. In other words, the exchange rate was considered unsustainable after 1995; this was well before the liquidity crisis in East Asia. The commercial banks had acted well before the devaluation. The Reserve Bank of Fiji (1997:Table 5) data shows that foreign currency-denominated assets as a proportion total assets of commercial banks rose sharply from the third quarter of 1996; this suggests that the commercial banks were suspicious of an impending devaluation.

The crisis in East Asia was affected of the devaluation, but the need for devaluation was on the wall well before the crisis. The data on money supply as a proportion of reserves, debt as a fraction of reserves, and interest rates all point in the direction of the unsustainability of the exchange rate peg after 1995. The question of substance is why the Reserve Bank of Fiji did not act well before January 1998 to realign the currency.

Policy options

The unsustainability of an exchange rate peg is a symptom of a more fundamental problem. A devaluation only attends to the symptom and cannot be the cure for the problems affecting the economy. Rigidities in the markets and inflexible prices, including wages, quickly neutralise any gains in competitiveness from a devaluation. When significant leakages from the financial sector take place as a result of corruption and mismanagement, the problems in maintaining prudent fiscal and monetary conditions are exacerbated, as has lately been demonstrated by the Fijian experience. Improving macroeconomic management, including prudential supervision of banks, is crucial for relieving the need for periodic and large devaluations.

The challenge is to chose policies and institutions that will work with the least capable administration. Such a strategy involves removing the scope for discretionary behaviour and introducing transparency such that the incentives for

Figure 5   **Fiji: short-term interest rates, 1982–96** (per cent)
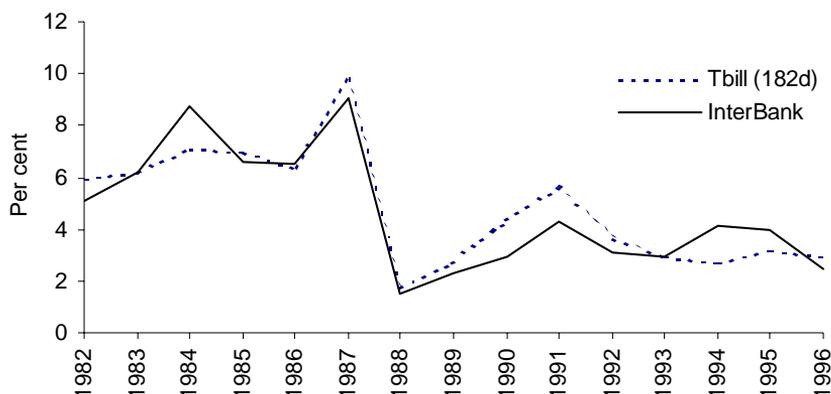
Source: International Economic Databank, The Australian National University, Canberra.

actions on the part of policymakers are in the favour of public interest. We consider a few of the options available. The first involves the overhaul and review of existing institutional arrangements to forewarn of the approach of a crisis in the financial sector. In this regard, the role and responsibilities of the central bank in prudential supervision of the banking sector have to be examined closely. In the particular case of the National Bank of Fiji crisis, it is essential to know why the approach of the National Bank of Fiji crisis escaped Reserve Bank of Fiji scrutiny. If the approaching crisis was recognised then why were remedial actions not taken by the Reserve Bank of Fiji before it reached a stage where the taxpayer had to come to the rescue to such a significant extent?

Second, public enterprises in Fiji have often required bailouts when the primary reason for their existence is to contribute to the budget. The options of privatising, or corporatising, if the above are not possible, then at least the hardening of budget constraints has to be considered. It is interesting to note that several public enterprises that run in competition with the private sector make losses while enjoying several substantial subsidies from the public sector when their private sector counterparts provide normal returns to their shareholders investments. The few public enterprises that do make a profit do so in a monopoly position; it is therefore instructive to separate out the monopoly rents from economic profits that these institutions make to get the true picture.

Third, discretion in the determination of the value of the Fiji dollar has to be removed; this can be done by either employing a currency board or through a clean float. Given the rigidities in domestic factor markets, the float is perhaps the better option. The main benefit arising out of a float will be that the value of the currency will provide a daily barometer on the soundness of macroeconomic management in the country. It is to be stressed that no particular exchange-rate regime will guarantee good financial management; a floating regime has the advantage of not requiring active management of the exchange rate as well as being transparent to the general public (Chand et al. forthcoming). Such transparency means that policymakers have the incentive to manage the economy in the national interest.

Furthermore, a fixed exchange rate regime encourages speculative activity. When a devaluation is eminent, those with the information and the liquidity can (and perhaps do) make quick profits at the expense of the nation at large. Such rent-seeking activity can only be counter-productive both in terms of GDP and national welfare (see Chand 1997). The redistributive impacts of a devaluation on equity considerations are equally alarming. A devaluation reduces the purchasing power of savers and those holding liquid assets and redistributes this income to debtors and those holding real (tradable) assets. As an extreme example, an individual with prior knowledge of an impending devaluation can make quick returns by engaging in currency swaps.[6] The size of these returns is directly proportional to the magnitude of the devaluation. At the other extreme, a retiree living on savings alone has their purchasing power reduced by the extent of the devaluation. Everyone lies in between these extremes, it would be hard to argue that a devaluation improves equity.

Finally, devaluations cannot be used too frequently as a policy tool. It encourages speculative activity, discourages holding domestic currency, raises uncertainty of profits from investment, and discourages savings (at least in domestic currency). All of the above hamper monetisation and reduce gains from financial intermediation; these collectively impinge on the level and

rate of growth of national output. If Fiji intends to free the capital account of the balance of payments then a robust and mature financial system is a prerequisite for success. The exchange rate would have to be transparent in such an environment. Such an outcome will be good for the national economy since it will impose an external discipline on domestic management of the economy. The recent scandals in the country suggest that we are in desperate need of such a discipline.

Conclusion

Fiji has had three large devaluations over the past decade; the frequent use of such drastic actions suggests a failure of other policy instruments in macro-management together with a failure of early warning devices of impending crisis. Devaluations only treat the symptoms hence can only be used sparingly and for short-term relief, too frequent use of such a policy instrument can have drastic side effects including demonetisation and failure of financial intermediation. Loss in the confidence in the domestic currency can shorten the period required to reach a liquidity crisis; such uncertainty will increase exchange rate risk and raise interest rates on domestic-currency denominated debt. All of the above hamper investment and growth of output.

The distributive consequences of a devaluation is equally alarming. It penalises savers, many of whom are workers who save through statutory requirements, such as the national provident fund. The gainers are those with debt and real tradable assets and inventories. Furthermore, frequent currency realignments encourage speculative activity and rent-seeking behaviour amongst such speculators.

The only solution to good macro-economic management is to have a transparent system that involves minimal discretion on the part of policymakers and people in positions of authority. This paper draws on the past experiences to suggest a more resilient stance in management of reserves, exchange rate, and the banking sector. The strategy suggested is one where policy is transparent, involves minimal amount of discretion on the part of bureaucrats, and allows all prices, including the exchange rate, to be market determined.

Financial markets are increasingly becoming integrated with global commerce, and such integration imposes discipline on the management of small open economies. The tolerance for mismanagement by domestic authorities is minimal, information and financial capital flows readily in electronic form over the telephone network. Disregarding these facts can only be to the economic disadvantage of the domestic economy; one Fiji can ill afford given the record over the last three and a half decades.

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Notes

1 Note that capital controls are at the cost
of reducing the availability of
international savings to domestic

investors and investment opportunities
to savers at home.

2 Even the United States, the largest player
in the global financial markets, is small
since it cannot impact on global interest
rates and cross-border capital flows.

3 The recent saga at the National Bank of
Fiji is a classic example.

4 Penn World Tables (Summers and
Heston 1991) data suggest that velocity
has remained constant at around 3 over
the last two decades.

5 In the normal circumstances, the T-bill
rate taken to be the risk-free rate, would
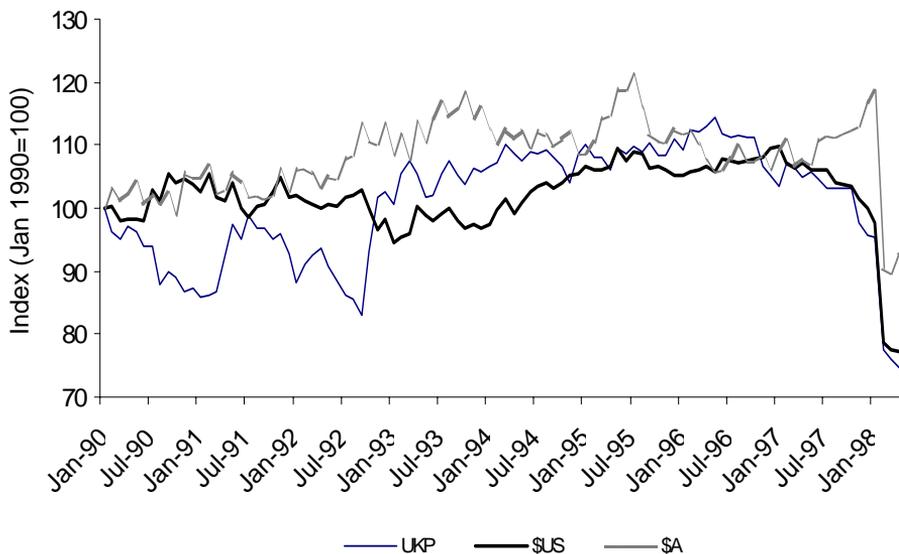constitute the interest rate floor.

6 Another possibility would be to short sell
in the domestic currency on the spot
market for foreign exchange and reverse
this transaction after the devaluation.

Appendix

Figure A1 **Exchange rate, units of foreign exchange required per F$, 1990–98**

Source: Datastream, values current as of May 1998.