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MACROECONOMIC POLICIES UNDER ADVERSE CONDITIONS: THE CASE OF FIJI IN 1987

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Fiji's financial and economic policies have been traditionally cautious.[1] External and internal financial stability were recognized as preconditions to steady long-term economic growth. External commercial debt was looked upon as the funding source of last resort. Public sector deficits were not always easy to contain, but strenuous efforts were applied annually to keep them under control. Private sector credit growth was closely monitored. Exchange rate variations were never considered sacrosanct, and variations were implemented whenever necessary. The maintenance of stable real effective exchange rates of the currency was an important objective. It was generally accepted that the early introduction of appropriate macroeconomic policies which pursue financial stability was preferable to allowing imbalances to develop to a point where IMF programs became unavoidable.

The Macroeconomic Committee that prepares short-term forecasts and the framework within which the annual budgets are prepared applies monetary targeting flexibly as part of its set of working tools. Projections are made of the net foreign assets, public sector deficits and credit to the private sector by the banking system. Within this framework judgments are attempted upon the crowding out issue, overseas borrowing, appropriate levels of the public sector deficit and credit to the private sector. These judgments, which are broadly constrained so that the growth in broad money equates with that of nominal GDP plus a margin reflecting modest increases in demand for money, determine the focus of fiscal and monetary policies which are incorporated in the annual budgets.

By 1986 and in the first quarter of 1987 the economy had markedly improved. The terms of trade had improved substantially. The rate of inflation was steady at below 2 per cent. Gross foreign reserves rose rapidly in the second half of 1986. They reached a level equivalent to six months of imports by year's end (Chart 1). The liquidity of the banking system improved markedly with rising foreign reserves (Charts 2 and 3) and money market interest rates fell sharply (Chart 5). The interest rates for unregulated large deposits of F$250,000 or more also declined rapidly.

The economy had turned around after continued low growth since 1980, and 9 per cent real growth in GDP was predicted for 1986. The climate

[1] See R. Cole and H. Hughes, The Fiji Economy May 1987: Problems and Prospects, Pacific Policy Paper No 4, Canberra, National Centre for Development Studies, 1988.

for investments was improving and a number of large projects were under consideration by overseas investors.

Given the stable internal and external financial position in the second half of 1986, Fiji's priorities were readjusted. Economic growth became the focus and broad money, which was rising rapidly with increasing foreign reserves, was allowed to increase at a rate much higher than justifiable under the guidelines (Chart 4). The accommodating monetary policy was aimed at lower interest rates and higher levels of investment demand.

The favourable conditions of 1986 continued into the first four months of 1987, but the coups of May and September changed the economic climate dramatically. Business and consumer confidence deteriorated quickly. Capital exports by residents and overseas controlled companies increased. Dividends out of accumulated profits were declared and remitted. Import bills were paid in advance and repatriation of export receipts was delayed. Suppliers' credit for Fiji importers quickly dried up. There was a sudden increase in the number of residents leaving the country. The increased capital outflow that stemmed from this process was unsettling but was perhaps not as serious as the accompanying loss of expertise and skills. The number of visitors to Fiji dropped sharply in the wake of the coups. Expected tourist receipts had to be revised downwards. After the first coup, the sugarcane farmers initially demonstrated their unhappiness by refusing to harvest their sugarcane. As Fiji was then in the midst of a severe drought, the delayed cane harvest resulted in substantial loss of output and foreign exchange receipts. The bans upon imports from Fiji imposed by the Australian and New Zealand trade unions persisted longer than the bans upon exports from those countries. The impact of these bans upon the Fiji export industries such as timber was immediate and painful. Foreign exchange receipts were forgone, sales plummetted, cash flow difficulties appeared and employment numbers and hours were reduced.

The impact of all the above developments upon foreign reserves occurred rapidly. Chart 1 shows the rapid decline in reserves following the first coup in May and the second in September. The figures are shown in Special Drawing Rights (SDR) so as to eliminate the revaluation distortions in the level of reserves due to the large devaluations of 29 June and 7 October.

In normal years, the trough in Fiji's foreign reserves occurs between June and August, reflecting the inflows from sugar receipts in the second half of each year. The trough in reserves in 1987 was shifted backwards and persisted for longer (Chart 1) because of the delayed sugar receipts. The high liquidity positions of the banks before the first coup had encouraged the extension of large unused overdraft facilities to the private sector. These facilities were employed to finance capital exports and the leads and lags in the current items of the balance of payments. The growth in commercial bank credit to the private sector consequently accelerated from May to September (Chart 6). The liquidity of the banking system dried up very quickly as foreign reserves fell and credit increased (Charts 2 and 3). Broad money growth rates decelerated sharply as the influence of falling reserves overrode that of rising credit (Chart 4).

The focus of policy had to change quickly. The preservation of the country's dwindling foreign reserves became the overriding objective and the monetary guideline was abandoned.

The Fiji dollar was devalued by 17.75 per cent on 29 June. This measure was aimed at the emerging imbalances in both the capital and current account of the balance of payments. It was to make capital exports and import of food and services expensive and to impart additional incentive to the tradable goods sector. Given the weakening trend in the labour market conditions as the economy contracted the positive impact of the devaluation of June and later of October upon the export sector was expected to be substantial.

Normally the Reserve Bank aims to maintain relatively stable real effective exchange rates (REER) for the Fiji dollar.[2] In recent years, given the need to improve the competitiveness of the economy, attempts were made to allow downward movements in the REER. Over a period of six weeks in the first half of 1986, the Fiji dollar was progressively devalued by 5 per cent against the basket of currencies to which it is tied. That was the year when incomes policy prescribing wage settlements well below the inflation rate was in place. The two devaluations of 1987, when labour market conditions were weak and salary reductions had to be accepted as the economy contracted, resulted in the REER falling even more steeply. The real effective rate index of the Fiji dollar fell from approximately 98 per cent to 91 per cent in the June quarter of 1986 and from approximately 87 per cent to 66 per cent during the September and December quarters of 1987 (Chart 7).

Initially the Reserve Bank accommodated the banks as their liquidity positions deteriorated. On 8 June the unimpaired liquid assets ratio, ULAR, was reduced from 18 per cent to 16 per cent. The Statutory Reserves Deposit Ratio (SRDR) was also reduced to 5 per cent from 6 per cent on the same day. But before the month was out, the banks were informed that the original ULAR and SRDR were to be restored.[3]

Other measures aimed at tightening the growth of credit followed. The penalty interest charge on shortfalls in the ULAR was increased to 0.07 per cent per day. The minimum lending rate (MLR) of the Reserve Bank, was raised from 8 to 9 per cent and later to 11 per cent. The rediscount window of the Reserve Bank was effectively closed. In considering access to this window the Reserve Bank took into account additional factors including the applicant bank's loan to deposit ratio, past record of reliance upon the Reserve Bank and performance with regard to lending to priority sectors. Privileged access was hardly granted even where conditions were met. The minimum rediscount rate, which was set at 0.2 per cent above the latest average discount rate at which tenders for treasury bills were allotted, was an effective disincentive.

Up to June 1987 interest rates were regulated. Maximum rates covering both sides of bank balance sheets were set from time to time. The exceptions were on large deposits equalling or exceeding F$250,000 held for at least thirty days, and securities issued by the public sector.

For a number of years the government issues of bonds and treasury bills were made through tenders. So too were the bond issues of a number of public sector corporations and the promissory note issues of the Fiji Sugar Corporation and the Fiji Electricity Authority. These large borrowers have been competing with banks for customers who invest in the deregulated large deposit market.

In the period of high bank liquidity, interest rates had sunk steadily downwards. The period after the first coup saw interest rates turning round and rising sharply as

2 See 'Fiji's weighted real exchange rate', PEB, June 1987; and Special Article in Reserve Bank of Fiji, Quarterly, September 1986.

3 See D.G. Luckett, Monetary Policy in Fiji, Institute of Pacific Studies of the University of the South Pacific, 1987, pp.70-3, and 76-8 for a description of these ratios.

reserves fell and bank liquidity deteriorated (Chart 5).

In early July 1987 interest rates were completely deregulated. The weighted average interest rate on bank loans and advances, which was less than 12 per cent in March, floated well above the previous maximum of 13.5 per cent in September. In the same month, the weighted average interest rates paid upon large deposits exceeding F$250,000 held over thirty days was 23 per cent.

The Fiji Electricity Authority, which experienced acute cash flow difficulties as sales dropped with the falling hotel occupancy rates, while its external debt burden rose with the two devaluations, had to borrow through promissory notes at yields exceeding 20 per cent from July to November (Chart 5).

Short-term lending to commercial banks may be unsecured or secured upon equitable hypothecation of acceptable securities deposited with the Reserve Bank. This is normally an overnight facility but may be extended over three or four days. As liquidity tightened banks showed growing interest in extending the period of this facility. As a deterrent, interest charges upon the facility were increased on 1 July, and graduated according to the period and whether or not the facility was secured or arranged beforehand (Chart 8). On 5 October, following the second coup, a further loading of 2 per cent was imposed across all the schedules shown in Chart 8.

On 7 October the banks were requested to reduce outstanding loans and advances to within the average levels of the third quarter of 1987. This request, the observance of which was not mandatory, was the only measure against credit growth that deviated from the market-related approach that the Reserve Bank had embraced. However, there was a negative incentive attached to the request. A bank which found itself unable to comply with it by 28 October had a further loading of 5 per cent upon any unsecured loan outstanding with the Reserve Bank from that date. Thus, a non-complying bank with an unsecured three-day advance was charged at a rate of 25 per cent. The corresponding rate for an advance over nineteen days or more was 33 per cent.

The Reserve Bank had pre-shipment and post-shipment finance facilities for non-traditional exports. The total outstanding under these facilities fluctuated around F$7 million. Exporters had access to cheap accommodation that was set at 5 per cent. The schemes were administered through the commercial banks which were allowed a 2 per cent loading to cover their administrative costs. These facilities were suspended in early October as part of the overall effort to contain the volume of bank reserves. Exporters who qualified under the schemes were predictably irate, but they were asked to consider the measure as a tradeoff against the benefits accruing to them through the two devaluations and the weak labour market conditions.

The refinancing of external loans through domestic credit, which was allowed when bank liquidity and foreign reserves were high, was suspended. All purchases of foreign exchange for servicing external debts in accord with existing loan agreements and for servicing capital were freely made. Overseas owned companies were, however, advised that dividends intended to be remitted had to be declared out of the current year's profits and preferably within the levels of the past few years. Other overseas payments for financing current international transactions were not interfered with. It was considered important that Fiji strictly honour ongoing external commitments so that the task of regaining the excellent external credit rating and the reputation as an attractive investment destination that it previously enjoyed would be easier.

Fiji is also an Article VIII member of the IMF. The provisions of this Article prohibits the country from controlling current international financial transactions. As the possibility of calling upon an IMF program was quickly becoming a reality it was considered important that Fiji remained a 'good' member of that institution.

However, exchange control measures upon capital financial transactions were tightened. It was recognized that these measures would have a negative impact upon confidence which was already at a low level. They were imposed with the announced intention of removing them once stability of the external sector was regained. Overseas investments by residents were suspended. Previously a resident might invest up to F$5000 each year in portfolio investments overseas. Emigrants who previously could export all their funds up to a year before departure were rationed in what they could take out. The head of an emigrating family was allowed only $4000 and each dependent member F$2000 upon departure. Depending upon family circumstances a maintenance allowance of up to F$3000 a month might be granted after departure. Fiji residents also faced reductions in the amounts that they could send out as gifts or as overseas travel allowances.

The financial position of the central government deteriorated sharply in the second half of 1987. As the economy contracted with falling investor and consumer demand, imports fell steeply. Taxes on international trade fell by some F$38 million below the original estimate for 1987. The yield on taxes on income and profits also declined rapidly. It was F$126 million compared to the estimated F$140 million for 1987 and was substantially lower than the amounts for the previous four years. In the wake of these developments and the increased government external debt service payments in Fiji dollars after the devaluations, the budget deficits would have widened substantially. Such a trend would have imposed a heavy burden upon domestic credit growth and the weakening foreign reserve position.

Expenditure cuts were therefore imposed. In early September salaries and wages in the public sector were reduced by 15 per cent. At the same time the salaries in the military were cut back by an average of 20 per cent. Debt service payments, which had risen, had to be honoured. As other non-emolument expenditures in the operating budget were already highly controlled, the only other major item of expenditure that could be reduced was the capital program. Through delays of implementation and cutbacks, the capital expenditures were reduced by more than F$20 million by year's end. Grants to the public sector corporations that remained to be disbursed in early September were cut back by 50 per cent. These corporations were also informed that they would have to do what commercial organizations would do in similar circumstances to survive, and that they might not expect any further financial support from the central government.

The expenditure reductions were painful, but they were not sufficient to contain the widening deficits, the financing of which created some difficulty. International commercial bankers, who in normal years regularly visited Fiji asking to lend to the government, were keeping their distance. They were polite but negative towards overtures from the Fiji government.

The Reserve Bank quickly found itself exposed. Its effort to float government securities in the market did not meet with success as the liquidity in the banks tightened. The yields on these securities had risen steeply (Chart 5); even so, the

Reserve Bank had to take up shortfalls in these issues. Security issues by other public sector corporations such as the Fiji Electricity Authority and the Fiji Development Bank met with the same response. As a result the Reserve Bank's exposure to the public sector increased rapidly from May to November 1987 (Chart 9).

The public's demand for money for speculative and precautionary purposes had increased substantially under the climate of uncertainty that prevailed in the second half of 1987. Demand for medium and long-term securities fell quickly. One-year government bonds were issued for the first time in response to the growing preference for money and liquid assets. Later six-month bonds were floated in an attempt to meet the changing attitude of potential investors. In the pursuit of this objective the interest rate on these issues was set according to the average weighted yield of tenders that were finally accepted.

While interest rates on loans and advances and large deposits were increasing rapidly in the deregulated market, rates on small bank deposits hardly moved. To ensure that banks competed effectively for small savings, the minimum amount for subscription to treasury bills was reduced from F$10,000 to F$250. The minimum subscriptions for the newly introduced six-month and twelve-month bonds were also set at F$250 to allow active participation by small savers.

The economy had begun to stabilize and consumer and business confidence were beginning to improve by September. But the second coup of 25 September undid all these gains. Tight credit and exchange control policies had to be maintained and strengthened. The second devaluation of 6 October became unavoidable.

The economy contracted by some 11 per cent in 1987. The contraction to which the tight monetary policy and expenditure reductions contributed helped in stabilizing the current account. The two devaluations were effective in containing capital flight and in promoting the favourable developments in the current account. Tight exchange control also helped contain the rate of outflow in the capital account. Tourism numbers and gross receipts fell far short of expectations, but sugar export receipts, thanks to the 178,000 tonnes of stock accumulated in 1986, exceeded F$200 million in the face of substantial falls in output consequent upon the drought and the delayed harvest.

By December, the external accounts were returning towards balance. Reserves were increasing: they were up to the equivalent of six months' imports by the end of February 1988 (Chart 1). Bank liquidity was improving rapidly (Charts 2 and 3). Money market interest rates were falling sharply (Chart 5) and bank lending rates were beginning to decrease. The commercial banks' exposure to the Reserve Bank was effectively liquidated by January 1988 (Chart 2). By December the government and public sector corporations were finding it easier to raise funds in the market and their exposure to the Reserve Bank was falling steadily (Chart 9).

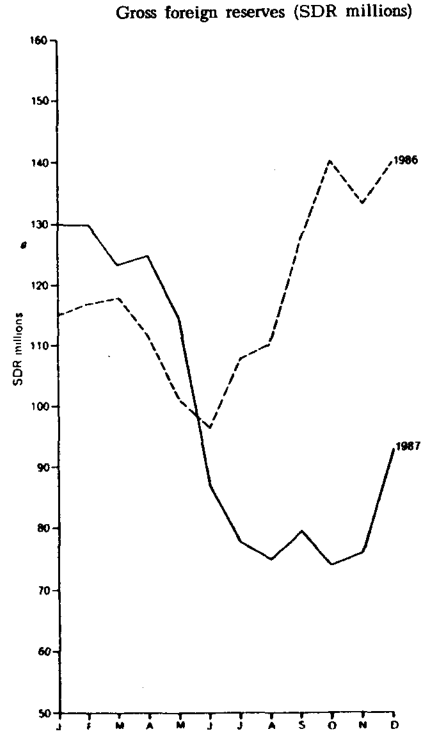
Chart 6 shows the rapid decline in the rate of growth in commercial credit to the private sector since September 1987. This trend is continuing despite the improvement in bank liquidity that began in December, and reflects the continuing weak consumer and investor demand in the economy.

In the wake of the two devaluations inflation accelerated from approximately 2 per cent to over 10 per cent (year on year) during 1987. The impact of the devaluations upon domestic prices is continuing. The ongoing weak labour market conditions and the contracting economy are predicted to help contain the average inflation rate for 1988 within 12 per cent (year on year).

The focus of macroeconomic policy in 1988 remains much the same as that of 1987. The budget deficit is being contained, although this is proving difficult as revenue remains weak, with projected further contraction in the economy and with the difficulty of further cuts in expenditure. Tight monetary policy is to remain in place. The Reserve Bank intends to carry a higher level of reserves than normal so as to ensure that possible imbalances in the economy stemming from unexpected internal or external shocks could be quickly and comfortably addressed with an appropriate blend of adjustment and financing. The real effective exchange rates of the Fiji dollar are to be stabilized at levels achieved after the 1987 devaluation.

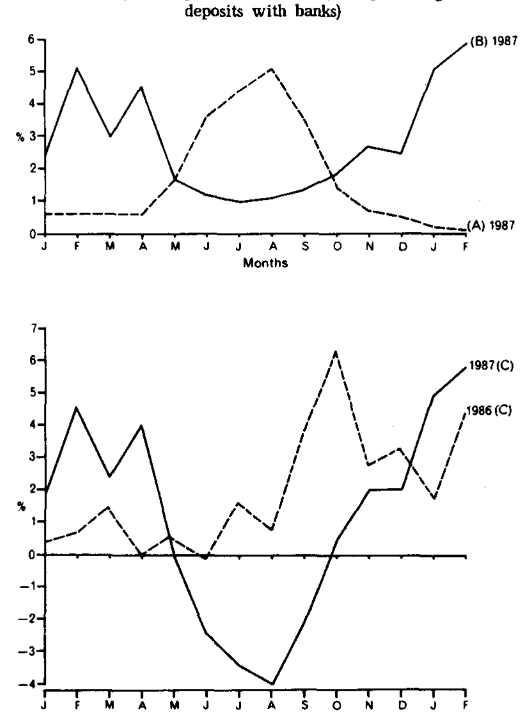
The outstanding issue for Fiji in 1988 and beyond is the rebuilding of confidence. This process will depend upon moderate and sensible political developments and upon the re-establishment of a democratic system of government in which all sections of the community feel comfortable. They have to be able to feel that the legal system under the new arrangement protects individuals' personal freedom and property. They will also need to be convinced that it will be lasting. With such a framework in place the restoration of trust and goodwill among and across all sections of the community will gain momentum. While this process is likely to take some time it will certainly take place. After months of economic difficulties and soul searching it is becoming increasingly clear to the people of Fiji that nation building and national prosperity call for goodwill, cooperation, moderation, and concern for the economically weak.

Chart 1
Gross foreign reserves (SDR millions)



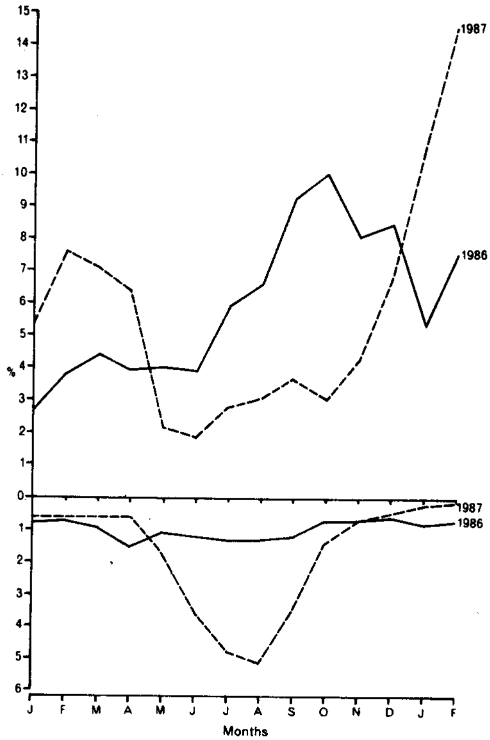
Source: Reserve Bank of Fiji

Chart 2
Liquidity of commercial banks, borrowing from the Reserve Bank (A) cash held at banks and banks' deposit with Reserve Bank (B) net posiiton (B)-(A)=(C) (as percentage of total deposits with banks)



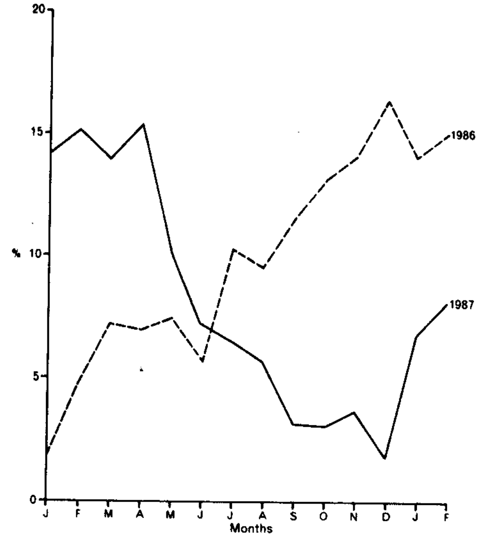
Source: Reserve Bank of Fiji

Chart 3
Banks' liquid assets (including cash in banks) margin (percentage of total deposits)



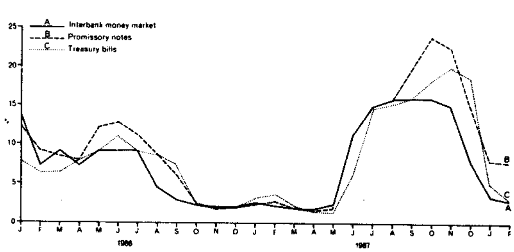
Source: Reserve Bank of Fiji

Chart 4
Broad money (M3) (year on year percentage change)



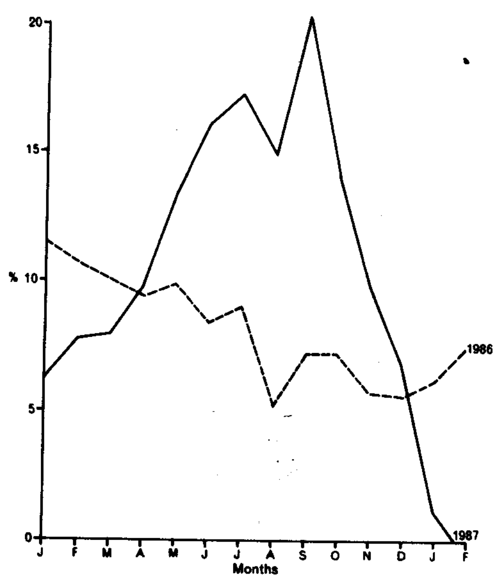
Source: Reserve Bank of Fiji

Chart 5
Money market rates



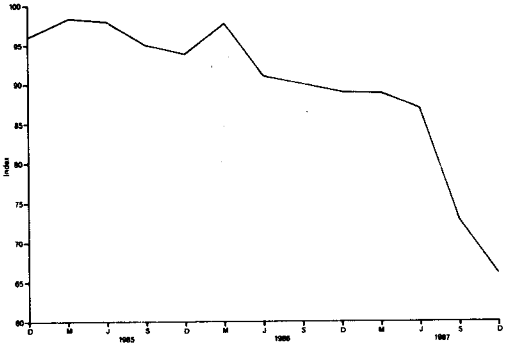
Source: Reserve Bank of Fiji

Chart 6
Commercial bank credit to the private sector (percentage change, year on year)



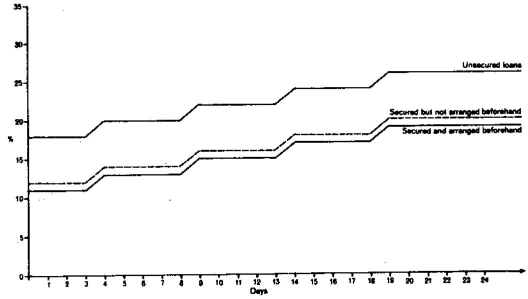
Source: Reserve Bank of Fiji

Chart 7
Real effective exchange rates of the F$ (March quarter 1979=100)



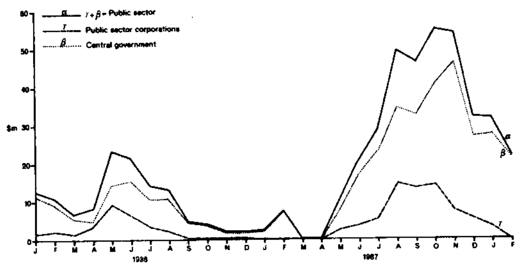
Source: Reserve Bank of Fiji

Chart 8
Reserve Bank interest rates upon loans to commercial banks (effective from July 1, 1987)



Source: Reserve Bank of Fiji

Chart 9
Claims by the Reserve Bank upon



Source: Reserve Bank of Fiji