# Inia Naiyaga: Exchange rate issues, monetary policy and inflation and more

Response by Mr Inia Naiyaga, Deputy Governor of the Reserve Bank of Fiji, at the USP Fiji Update, Suva, 16 September 2011.

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***Professor Biman Prasad and his Team at USP***

***The Diplomatic Corp***

***Distinguished Speakers***

***Ladies and Gentlemen***

A very good morning to you all. Thank you for the kind invitation to respond to the three papers that have just been presented today. I also take this opportunity to thank all the authors of the paper for their efforts in preparing their papers and also to Professor Biman's Team for the excellent arrangements for this event.

My response will be on the issues relating to the exchange rate, monetary policy and inflation, Fiji's economic performance and some exchange control issues.

## 1. Exchange rate issues

a. There has been a growing tendency with empirical support towards more flexibility in the choice of exchange rate arrangement, globally. However, a more flexible exchange rate does not necessarily boost investor confidence as we have seen that most developing countries are currently trying to cope with the volatility of exchange rates. ***The pros and cons of moving to a more flexible exchange rate regime should be considered carefully.***

b. The Reserve Bank reviews its exchange rate policy to ascertain its effectiveness and appropriateness in supporting its twin objectives of monetary policy – that is maintaining low inflation and maintaining an adequate level of foreign reserves. The Fiji dollar is pegged to a basket of five currencies (US dollar, Australian dollar, New Zealand dollar, Japanese yen and the Euro). The Reserve Bank assessed and evaluated the possibility of a flexible exchange rate regime with technical assistance from the International Monetary Fund last year. The move towards greater flexibility remains in consideration by the Reserve Bank. ***While the benefits of a more flexible exchange rate regime are clear, the timing needs to be carefully considered.***

c. We note the finding in Dr Jayaraman's paper on the impact of Fiji's exchange rate pass through to inflation. ***We noted that the conclusion of the paper is in line with our internal assessment of the exchange rate pass through effect.*** The paper concludes that during the post coup period, a depreciation of Fiji's domestic currency by ***1 percent*** raises domestic prices by ***0.37 percent***, similar to our internal assessment of ***0.4 percent***.

## 2. Monetary policy and inflation

a. Regarding Dr Patrick's paper on RBF's commitment to its monetary policy objectives given the current economic background – ***The RBF remains committed to its twin objectives – that is to maintain low inflation and an adequate level of foreign reserves.*** Inflation has been high at the moment and reached 10.4 percent last month. As we all know, ***the inflation outcome has been influenced by external and policy related factors – most of which are beyond the control of monetary policy.*** Imported inflation alone accounts for more than 60 percent of our domestic inflation outcome. With the current demand side inflationary pressures weak at the moment, it is more appropriate that monetary policy remain accommodative to support some growth in the economy while at the same time vigilant on the potential second-round impact on inflation. Inflation is forecast to subside to 7 percent by the end of this year and further to 4.5 percent by the end of next year.

b. On to core inflation – in principle monetary policy should only respond to persistent price movements. The Reserve Bank has two core inflation measures which are the ***trimmed mean and excluding food and energy items inflation***, both are widely accepted and used in many central banks to exclude temporary price pressures. Universally, it is hard to determine when that "temporary" impact will come to an end as there are a lot of factors that come into play at almost the same time. In Fiji, the big increase in food inflation from June 2010 to June 2011 to 11.3 percent was attributed to many factors. If we compare food inflation from June 2010 to December 2010, food prices only rose by around 2.0 percent which can be regarded as quite stable. As such most of the increase in food inflation only came about this year on account of the VAT rate change and the high food prices noted across the world during this period. By January 2012, we should see the impact of VAT fall from the core inflation measure. As to the impact of high world food prices, as soon as prices of these food commodities normalise abroad, core inflation should return to normal levels.

c. It was mentioned that Fiji had high rates of inflation by the middle of this year even after accounting for the impact of higher electricity tariffs and the increase in VAT which came into effect in November last year and January this year respectively. It was also mentioned that Seychelles which despite having a larger devaluation managed to bring down inflation to the same rate as Vanuatu. It is important to note that unlike ***Seychelles***, Fiji's major trading partners are Australia and New Zealand which are the major source markets for our imports of food, beverages and manufactured goods. The strong appreciation of the Australian and New Zealand dollar over the year has exacerbated the impact of already higher import prices feeding through to domestic inflation. These explain the large difference in the inflation rate in Fiji by mid 2011 even after accounting for the VAT and electricity price increases. On ***Vanuatu***, we find their low inflation rate presented this morning very intriguing and we will talk to our counterpart about their experience.

## 3. Domestic economic performance

a. The presentation by the IMF Regional Resident Representative – Dr. Yongzheng clearly highlights ***the performance of Pacific Island countries particularly Fiji since the global downturn in 2008 coupled with the renewed risks and policy challenges given current developments especially in the advanced economies.***

b. ***We also agree that Fiji economy had a weaker recovery in 2010 from the contraction in 2009.*** While tourism and manufacturing picked up, in 2010, the sugar industry declined. However, other exports did pick up significantly in 2010 due to a rebound in global demand and also improvement in terms of trade for certain resource commodities such as gold, forestry and fish products.

c. ***We need to note that the significant migration of skilled labour force has affected Fiji's growth potential, which may explain why the recovery in the Fiji economy – despite its advantages – to some extent has been slower that most PICs.***

d. ***The paper also raised some valuable points for Fiji and the Government has already taken steps to implement some of these.*** The ***establishment of the Land Bank*** is to encourage landowners to deposit land so that it can be leased out under long term tenure for commercial purpose use. The response from the land owners has been encouraging so far with the area of land deposited in the Land Bank surpassing the 2011 target in June. ***Sugar reforms*** are also underway with the Government taking the lead role in addition to allocating around $122 million in the 2011 Budget to support the sugar industry directly. Apart from the sugar industry, there is an urgent need to fast track other ***public sector reforms*** to ensure long-term macroeconomic stability.

e. ***The good news is that a stronger rebound in our domestic economy is envisaged for this year with growth expected across most sectors except for the construction sector.*** The current performance of most sectors to date have been mixed, with positive performances reflected in the tourism and related industries although other sectors remained weak. The economy is expected to grow by 2.7 percent in 2011, however, this figure is currently under review. The new figure is expected to be announced during the 2012 Budget Address.

f. As mentioned in the presentation, the growth in remittances is encouraging and should support consumer spending, particularly in a time of sluggish economic growth. ***Looking ahead, we agree that it would be prudent for such funds to also be directed towards investment spending. Ongoing financial literacy education by the RBF, financial institutions and others, could encourage families who are recipients of remittance funds, to invest these money in income and revenue generating activities.***

g. ***The views expressed on the effects of devaluation are noted.*** It is important to recognise that the positive effects of the devaluation were partially overshadowed by the downturn in global demand and the Fijian economy would have been in a much worse position now without the adjustment. We continue to encourage our exports sector to take advantage of this competitive gain by producing more to then be able to export more to other countries.

## 4. Exchange controls and other clarifications

a. ***A statement made earlier by Dr Patrick regarding exchange controls needs to be corrected.*** The Reserve Bank assures all foreign investors that all funds introduced into Fiji including all profits are free to be repatriated at any time. At times, the outflow is staggered for large amounts, like in the case of commercial banks. Over the last 6 years, a total of ***$1.05 billion*** was approved as outflows for profit remittances.

b. In responding to the concerns on the compulsory surrender of foreign exchange, the Exchange Control Act states that all foreign exchange are to be sold to a foreign exchange dealer. However, ***in order to cover for exchange rate risks, we have been allowing companies and businesses to hold foreign currency accounts to meet overseas payments – the total in these accounts currently stands at $100 million.***

c. ***Regarding our foreign reserves cover, the Reserve Bank is now targeting 4–5 months of imports cover, higher than the standard benchmark of 3 months.*** The standard benchmark of foreign reserves is under study at the moment especially at the IMF given the growing complexity of our financial system and the associated increased vulnerability factors. We are doing well and at the moment, our foreign reserves level at $1.6 billion is sufficient to cover around 4.8 months of goods and non-factor services.

d. Minor observation – It was noted in the first paper that we have six banks – ***we have four commercial banks and a development bank.***

## Conclusion

With the current challenges in our economic environment both globally and domestically, the ***Reserve Bank has been proactive in its roles to support our economic recovery.*** We have eased our monetary policy stance and more recently we have been conducting moral suasion with the commercial banks in an effort to stimulate investment and credit especially to the priority sectors and support growth in domestic demand. We have and will continue to relax exchange controls in order to support overseas current payments which are conducive for business growth. This will also instil confidence to the investors and encourage investment as well. ***The Reserve Bank has rationalised and introduced the Import Substitution and Export Finance Facility which all exporters and businesses*** may access to boost exports and reduce imports. Energy renewable projects also qualify for this facility. $40 million is available under this scheme and the current usage is $20 million. The RBF lends funds to commercial banks, credit institutions and FDB at 2 percent and these lending institutions are allowed to charge interest rates up to a maximum of 6 percent.

The current Government's concerted effort is vital and timely and we also ***support the call made by this panel for more variants on fiscal and incomes policies given the limitations faced by the monetary authorities.*** Nevertheless, a more positive outlook remains ahead with the reforms taking place and as the current mix of monetary and fiscal policies are aligned.

From the presentations that we have heard so far, investment is the key. We need to address all the obstacles to investment and address them accordingly. We need to ensure that the environment is conducive as well. It is also important that Fiji attracts the right type of investors.

We have heard a lot of issues and questions so far. What we need is solutions – practicable and relevant solutions that can be implemented.

Finally, I would like to add that this type of dialogue is healthy and provides an excellent platform for exchange of ideas so that we can all work together and move forward for a better Fiji.

Thank you.