RESERVE BANK OF FIJI ECONOMIC FOCUS

Why Do We Need Foreign Reserves?

We hear a great deal about foreign reserves, but what exactly are they, how do we earn them and why are they necessary? We will attempt to answer these questions in this article. In the interest of many of us who are not economists, we will sacrifice technical rigor and keep the economic argument simple.

Well, Fiji's *official* foreign reserves are those assets that are held in foreign currencies by the Reserve Bank of Fiji (RBF). There are also *unofficial* reserves held outside the RBF and we will discuss this later on in this article.

How do we earn these foreign reserves? There are many sources. But we receive the bulk of these foreign currencies from those in other countries that buy our exports, from those that lend us money, from tourists and from those that send money to us in Fiji.

Under the Exchange Control Act, companies and people of Fiji that receive these foreign currencies, are required to bring these monies to Fiji and exchange them for Fiji dollars at licensed money exchange dealers like commercial banks. In turn, commercial banks are required to sell these foreign currencies to the Reserve Bank at the end of each working day. The RBF invests these foreign reserves in the major financial markets around the world.

Why should ordinary citizens worry about our foreign reserves? Economic pundits are constantly telling us that they must not be permitted to fall below a certain level. If we run out of reserves, they say that Fiji becomes bankrupt. Bankrupt? Surely that could never happen, can it? Yes it can.

Why do we need these foreign reserves? There are basic reasons:

- Firstly, Fiji does not produce or manufacture all the commodities and products we require. So, we have to buy many millions of dollars worth of goods and services from overseas. It's a very long list … food, medicines, machinery, vehicles, equipment, household appliances, electronic goods, footwear, clothing etc; and

- Secondly, the overseas companies selling these goods to Fiji don't want to be paid in Fiji dollars. They want payment in a foreign currency commonly used for international trade – American dollars, Japanese yen, Australian dollars and others. Fiji, therefore, has to make sure it has enough of these currencies to pay for our imports.

Could Fiji ever run out of foreign reserves? Yes, this could happen if our export earnings do not keep up with our demand for imports. There wouldn't be enough foreign exchange to purchase imports, or to pay our national debts abroad.

Supermarket shelves would be empty of all those imported food products. Hospitals wouldn't be able to treat the sick properly because of a shortage of drugs and medicine. Buses and boats would be idle, their owners unable to purchase fuel.

Businesses and factories would close, crippled by a lack of goods, raw materials, equipment, machinery and other things they need from overseas. This would lead to unemployment and a whole host of other problems.

These things have actually happened in some countries. So, as you can see, it is very important that Fiji maintains an adequate level of foreign reserves. This responsibility falls on the RBF. They have to ensure that we have enough reserves. To help us earn more foreign reserves, Fiji has to vigorously promote exports.

What is the adequate level of foreign reserves that we should keep? While there are several measures of this level, the appropriate measurement depends on the individual country's circumstances and preferences. The global rule of thumb is that we should keep reserves equivalent to about 3 months of imports.

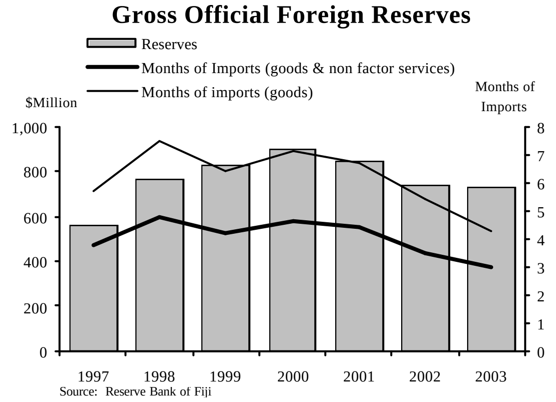
The RBF has progressingly allowed certain institutions (such as the Fiji National Provident Fund (FNPF) and other non-bank financial institutions) and even companies to hold foreign currency assets.

Because they are held outside of the Reserve Bank, these reserves are sometimes referred to as *unofficial* foreign reserves. But nevertheless, these reserves help meet the country's obligations abroad. Companies are of course free to use their reserves to pay for their imports.

The RBF had approved the reserves that are held offshore by the FNPF and other non-bank financial institutions. One of the conditions of the RBF approval and accepted by these institutions was that, these reserves would be recalled by the RBF if they were needed.

Therefore, these reserves are also available to pay for our imports and can be taken into account in calculating the broader definition of the adequacy of our reserves.

At the end of 2003, official foreign reserves held by the Reserve Bank was $727 million, equivalent to 4.3 months of imports of goods only.



The foreign reserves held by non-bank financial institutions were $219 million. Therefore, if we add the two together, the total national foreign reserves that are available to meet our foreign currency obligations were $946 million, which is equivalent to 5.9 months of imports of goods only.

Finally, a high level of foreign reserves does not necessarily reflect a strong economic performance, as they may simply be a result of low demand for imports arising from slow economic growth. This was the case for Fiji after the 2000 political crisis. However, a very low level of reserves is normally a signal that the economy is growing at an unsustainable rate. The key is to target and maintain a level of reserves that can be sustained over a long period of time.

To ascertain this "right" level of reserves for the country, we must take into account the total economic picture including future forecasts. However, in any situation, the best proactive policy is to raise the country's exports.

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