RESERVE BANK OF FIJI ECONOMIC FOCUS

The Impact of Exchange Rate Movements on Trade

Passing by a commercial bank or foreign exchange dealer, you would have noticed exchange rates posted on their windows. Have you ever wondered how these numbers are obtained, why they change from day to day and how these movements impact Fiji's trade? We will attempt to answer these questions in this article.

Firstly, let us go over the basics – what is an exchange rate? Well, an exchange rate is simply the value or price of one currency in terms of some other currency.

The Fiji dollar is pegged to a weighted basket of currencies of Fiji's main trading partners – Australia, New Zealand, the United States, Japan and the Euro-zone. What this basically means is that, using a special formula, the Reserve Bank of Fiji (RBF) calculates the official exchange rate for the Fiji dollar, taking into account exchange rates for the currencies of our major trading partners.

This is often referred to as a "trade weighted basket of currencies". The weights of each currency in the basket are determined by our trade with these countries.

So what is a Fiji dollar actually worth in comparison with other currencies? How is its value derived? Each day, the RBF calculates the official exchange rate for the Fiji dollar and releases this rate to commercial banks and foreign exchange dealers. This is the price at which the commercial banks can buy and sell foreign currency with the RBF.

The commercial banks and foreign exchange dealers use the official exchange rate for the Fiji dollar, provided by the RBF, to establish their own list of values of overseas currency. These are the lists you see on their window fronts.

Now if you observe these lists, you will notice that the exchange rate of the Fiji dollar against the various currencies changes from day to day. When the value of the Fiji dollar increases in comparison to other currencies, we say that the Fiji dollar has strengthened or appreciated. Alternatively, when the value of our dollar declines, we say that the Fiji dollar has weakened or depreciated.

What drives these movements? The movements of the Fiji dollar are entirely a result of the movements in the major currencies in our basket in the international currency market.

For instance, over the year to December 2003, the Fiji dollar strengthened by almost 20 percent against the US dollar. This largely reflected the weakening of the US dollar, as a result of its relative weak economic performance.

Because Fiji pegs its exchange rate to a basket of currencies, there are bound to be periods of upward and downward movements in the value of the Fiji dollar in the short-term. As we strengthen against one currency, we also weaken against others. However, over the long-term, our currency will be stable.

Therefore, as the Fiji dollar strengthened against the US dollar, it also weakened against the Australian and New Zealand dollars by around 10 and 4 percent, respectively.

So how do the movements in the Fiji dollar impact Fiji's trade? Generally, if the Fiji dollar strengthens against a particular currency, say the US dollar, it will be cheaper to buy or import goods that are priced in US dollars. Our payments for these goods in Fiji dollar terms fall in the short-term.

However, the strong Fiji dollar against the US dollar also means that we will earn less from exports priced in US dollars. Moreover, it makes our goods expensive in US dollar terms, so demand for such goods by US consumers may fall.

The opposite happens when the Fiji dollar weakens against a particular currency – on one hand, it will be more expensive to buy goods and on the other hand, we will earn more for our exports.

But what would be the overall impact on trade? While it is somewhat easier to trace how movements in the Fiji dollar will impact individual items traded in one currency, it is much more difficult and complicated to gauge the impact on overall trade because it involves many items that are traded in many different currencies. In addition, apart from changes in the exchange rate, there are other factors that simultaneously affect the demand and supply of imports and exports.

All in all, we must remember that in the short-term, fluctuations of the Fiji dollar against other currencies will occur. Most importantly, however, Fiji's exchange rate will remain stable in the long-term.

RESERVE BANK OF FIJI