WHY DO WE NEED FOREIGN RESERVES?

What is Foreign Reserves?

Foreign exchange reserves[1] are pools of foreign currencies held by central banks to assist the international trade of goods and services. For instance, the Reserve Bank of Fiji (RBF) currently holds on average the equivalent of around F$2.1 billion in the currencies of our major trading partners, which are the United States, Australia, Euro zone, UK, Japan and New Zealand. These currencies represent the balance of money received from all our exports; tourists who visit our shores, relatives and workers that live abroad (remittances), investments in Fiji made by foreign companies and countries and organisations that lend to Fiji, after subtracting our payments for imports, debts and other external obligations.

Why do we need Foreign Reserves?

Foreign reserves help pay for Fiji's imports since we do not produce all the goods we need. They also assist us in meeting our external debt commitments and, facilitate transactions by our people who travel abroad and need foreign currencies.

The following example illustrates how foreign reserves are used in international trade. Assume a Fiji importer buys rice from Australia. Since the importer needs to pay for the rice in Australian dollars, the importer will have to exchange his Fiji dollars for Australian dollars. In practice, the importer will convert the Fijian dollars into Australian dollars at a commercial bank here in Fiji, and have the bank send the foreign currency to his Australian counterpart from whom he is buying rice.

If the commercial bank needs additional foreign exchange to meet the demand of its customer, it will buy these from the RBF, causing the foreign exchange reserves to fall.

On the other hand, when a bank receives foreign money (for example, from a Fiji exporter as proceeds from the sale of Fijian goods abroad), it will need to change the foreign currency into Fiji dollars so that it can be used locally. The banks will then on-sell the surplus foreign currency to the RBF, thus increasing the level of foreign reserves.

The level of foreign reserves increases when foreigners buy more goods and services produced in Fiji, while it declines when residents take out money to buy foreign goods and services.

For a small economy like Fiji that depends on other countries for goods and services and whose currency is not widely used internationally, it is crucial that it has an adequate supply of foreign currencies readily available for Fiji importers. Otherwise, importers will not be able to pay for the goods they wish to bring into Fiji. A country faces external financial difficulties when it does not have enough reserves to meet its external obligations. Economists often refer to such a situation as a balance of payments crisis.

Role of the Reserve Bank of Fiji

One of the dual objectives of the RBF's monetary policy is to ensure that there is always a sufficient level of reserves or

[1] Fiji's official foreign reserves are those assets that are held in foreign currency by the RBF and other institutions, like the Fiji National Provident Fund and private companies as allowed by the Reserve Bank.

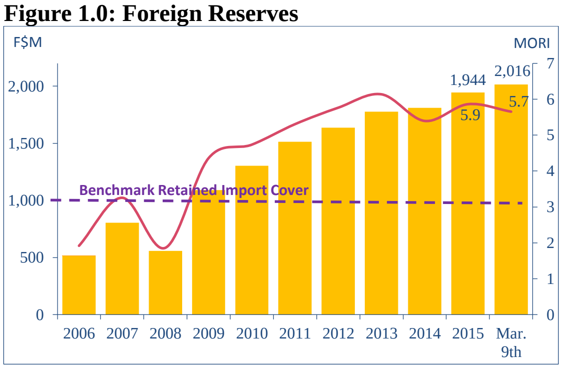
foreign currency to cater for Fiji's import needs. This objective is achieved through various monetary policy tools such as changes in the policy interest rate, required bank reserve ratios and lending targets as well as exchange control regulations which regulate the flows of money into and out of Fiji. The timely implementation of appropriate macroeconomic policies is important to ensure that there are no undue pressures on reserves, in either direction. In addition, our foreign reserves are held in safe, liquid investments, mainly in the currencies of our major trading partners so that they are readily available when needed. The RBF also monitors and forecasts these flows to ensure that they provide adequate cover in months of retained imports.

What is the adequate level of foreign reserves that we should keep?

While there are several ways of measuring the sufficient level of foreign reserves, the most appropriate measurement would take into account the individual country's circumstances and preferences. Nevertheless, a standard rule of thumb is to maintain reserves equivalent to the value of about 3 months of imports. Hence when the RBF reports on its foreign reserves holdings, you will often see a reference to the approximate months of imports those reserves would be sufficient to cover.

As Fiji is a small open economy affected by external factors such as rising commodity prices and natural disasters, the RBF targets to have a buffer above the international benchmark. In this regard, our current target is a minimum of 4 months of retained import cover (MORI). This level is deemed fairly comfortable and allows for good response time in the event of a sudden shock or natural disaster.

Figure 1.0: Foreign Reserves



Source: Reserve Bank of Fiji

As at 9 March 2016, foreign reserves at the RBF were around $2,016.1 million, sufficient to pay for 5.7 months of retained imports. In other words, the reserves held by the RBF on 9 March were sufficient to pay for close to 6 months of retained imports even if there was no other money coming into the country during that period. In addition, when we include foreign currencies held by other Fijian institutions and companies as allowed by the RBF, official foreign reserves as at 9 March 2016 were around $2,710.7 million, sufficient to cover 7.6 months of retained imports.

While Fiji's current reserve levels are healthy by international standards, these levels are influenced by large inflows from tourism earnings, remittances, and sugar export proceeds as well as large outflows from payments for mineral fuels, machinery and transport equipment, and food.

As such, the RBF closely monitors changes in reserves and regularly reviews its forecast to ensure that reserves levels and import coverage remain adequate and comfortable.