The Impact of Exchange Rate Movements on Trade

Many individuals and businesses receive foreign currency from friends and family members or business associates who are living abroad. This foreign currency has to be taken to a commercial bank or a foreign exchange dealer to be converted into Fiji dollars. This conversion is done using an "exchange rate – in this case, defined as the amount of Fiji dollars per unit of foreign currency." As one would discover the next time they would like to convert foreign currency into Fiji dollars, the exchange rate changes. How is the Fiji dollar exchange rate determined and what impact does its changes have on Fiji's trade with the rest of the world? This article attempts to answer these questions.

The exchange rate of the Fiji dollar is determined via a fixed exchange rate system whereby the Fiji dollar is pegged to a trade weighted basket of currencies of Fiji's main trading partners – Australia, New Zealand, the United States, Japan and the Euro zone. The weight of each currency in the basket is determined by its importance to Fiji's trade in goods and services

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

Commercial banks and foreign exchange dealers use the official exchange rate of the Fiji dollar provided by the RBF, to establish their own list of cross rates for currencies other than the US dollar. These are the lists you often see publicly displayed by these institutions.

What causes the Fiji dollar exchange rate to vary from day to day? When the value of the Fiji dollar increases relative 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 against other currencies. Movements in the Fiji dollar reflect the movements in the major currencies in our basket in the international currency market.

But why do movements happen in the international currency market? These could be explained by the country's economic and financial performance. For instance, in January this year, the Fiji dollar depreciated against the US dollar by 1.5 percent following an increase in the US Federal funds rate range to 0.25-0.5 percent from 0.0-0.25 percent by the Federal Reserve, which reflected an improvement in growth prospects for the US economy. However, in March this year, the Fiji dollar appreciated by 0.4 percent against the New Zealand dollar after the Reserve Bank of New Zealand reduced its Official Cash Rate to 2.25 percent from 2.5 percent, on concerns that weaker commodity prices and lower inflation expectations may undermine growth.

Because Fiji pegs its exchange rate to a basket of currencies, there are simultaneous 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 has remained relatively stable against the currency basket.

Impact on Trade

Let's look at the impact of these movements in the exchange rate on Fiji's trade. Changes in the value of our currency can affect the value of our imports and exports. Basically, if the Fiji dollar appreciates against another currency, let's say the US dollar; it becomes cheaper for Fiji to import goods paid for in that currency. Moreover, since a large chunk of goods in Fiji are imported, our payments for these goods in Fiji dollar terms fall in the short term, which benefits the country.

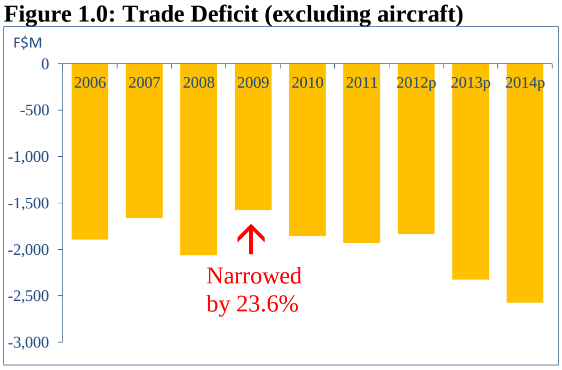
However, the downside to having a stronger Fiji dollar is that our exports become expensive in US dollar terms so other countries that use the US dollar, would find it expensive to buy our goods and services. Since Fiji relies on foreign income received through tourist spending, remittances, and exports of goods such as sugar, gold, mineral water and others, a stronger Fiji dollar vis-a-vis the US dollar for instance, would lower receipts for these goods and services in Fiji dollar terms in the short term which hurts the country.

Impact of the Fiji dollar Devaluation

Fiji devalued its currency in 1987 (twice), 1998 and 2009. In April 2009, the Fiji dollar was devalued by 20 percent against the basket of Fiji's trading partner currencies. The primary purpose of the devaluation was to protect Fiji's external position which had deteriorated rapidly due to high commodity prices in 2008 leading to higher import payments, further worsened by the floods in early 2009 and the adverse impact of the Global Financial Crisis (GFC) on our exports and tourism sectors.

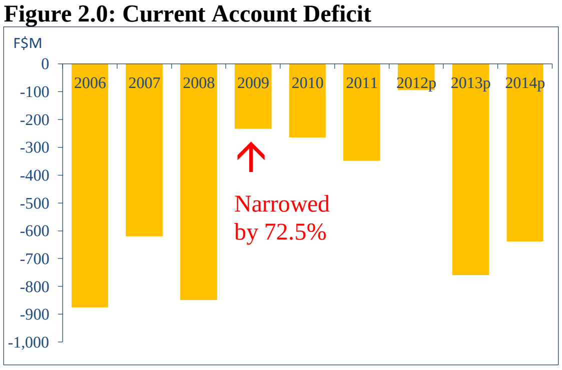
Following the devaluation, Fiji's international competitiveness improved as the Real Effective Exchange Rate (REER) index[1] of the Fiji dollar fell by 21.2 percent over the year to May 2009. The devaluation helped to narrow the trade deficit and current account deficit by around 24 percent (Figure 1.0) and 73 percent (Figure 2.0), respectively in 2009, mainly due to higher tourism receipts and exports of gold, mineral water, and fish as well as a slowdown in imports growth (Figure 3.0).

Figure 1.0: Trade Deficit (excluding aircraft)



Source: Fiji Bureau of Statistics

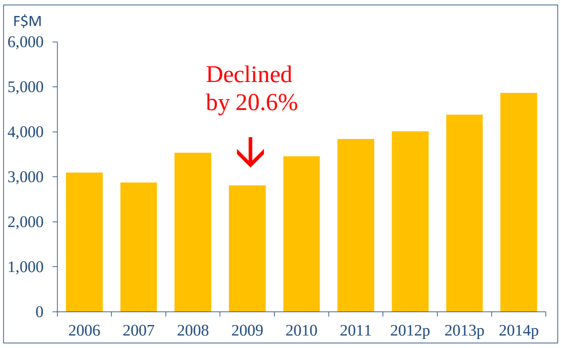
Figure 2.0: Current Account Deficit



Source: Fiji Bureau of Statistics

[1] The REER index is the sum of each component of the NEER index, adjusted by the relative price differential between Fiji and each of Fiji's major trading partners. The index measures the competitiveness of the Fiji dollar against the basket of currencies. A decline in the REER index indicates an improvement in Fiji's international competitiveness.

Figure 3.0: Imports (excluding aircraft)



Source: Fiji Bureau of Statistics

Summary

It is important to note that while changes in the exchange rate can have a notable impact on Fiji's trade, there are other factors that also affect the demand and supply of the country's imports and exports of goods and services. Furthermore, tracing the effects of exchange rate movements on overall trade is complex given the huge volume of goods and services and different currencies in which Fiji trades. Nevertheless, notwithstanding any shocks, while fluctuations in the exchange rate of the Fiji dollar against other currencies are inevitable over the short term, the Fiji dollar is expected to remain stable against the overall weighted basket of currencies of Fiji's main trading partners over the longer term.