

What Should be the Monetary Policy Objective of the Reserve Bank of Fiji?

Chandra P. Dulare

Abstract

This paper focuses on the appropriateness of the objective of monetary policy in Fiji. The Reserve Bank of Fiji Act (1984) entrusts the Reserve Bank of Fiji (RBF) with a number of purposes. The purpose that relates to monetary policy stipulates that the RBF shall foster credit and exchange conditions conducive to the orderly and balanced economic development of the country. The RBF, however, conducts monetary policy with the objective of price stability. Using current theoretical and empirical knowledge concerning the relationships among relevant macroeconomic variables in Fiji, this paper attempts to ascertain whether the objective of price stability is appropriate for Fiji.

Introduction

The Reserve Bank of Fiji (RBF) Act was passed into legislation in 1984. Since then, it has undergone only minor amendments. Given the very significant developments in the theory and practice of central banking, as well as in the developments in the financial system in Fiji and abroad, and in the experiences of the RBF over the last two and a half decades, the time is appropriate to re-look at the RBF Act. There are a number of elements in the Act that need to be reviewed. This paper focuses on only one element: the purposes of the RBF. There are other elements like governance, composition of the Board, relations between government and the RBF, and the like, that also need to be reviewed. The four purposes of the RBF as stipulated in the RBF Act relate to currency supply, monetary stability, sound financial structure, and balanced economic growth. This paper focuses specifically on the last purpose of the

RBF, a purpose that can be seen as a monetary policy objective. The Reserve Bank of Fiji, however, conducts monetary policy based on an expressed objective of price stability. This paper attempts to ascertain whether the objective of price stability is appropriate for Fiji.

Why do central banks exist separate from government?

Analysts, policy makers, and practitioners have to understand at the outset that a central bank is essentially a public institution. As such, a central bank exists exclusively for the good of the public. It does not exist *per se* to ensure, for example, that the financial sector remains stable and solvent. The reason why a central bank needs to be concerned about the solvency and stability of the financial sector is that if the financial sector collapses, the entire population is adversely affected. In fact all recessions, whether global or domestic, have been followed by financial collapses. The other reason why central banks are and should be concerned about the solvency and stability of the financial system is that it is through the financial sector in which central banks attempt to influence the economy. The financial sector is the environment in which central banks operate to implement policy entrusted to them. If the financial sector goes belly up, central banks do not have an environment to operate in. So it has to be borne in mind that central banks are public institutions, with implications for responsibility, answerability, accountability and transparency, and that they operate in the domestic financial environment to implement policy.¹

In spite of the fact that a central bank is a public institution, there are very good reasons why it should not operate as a department of the Ministry of Finance but be legislated to operate at an arms length from government. An extensive literature exists on why this should be so and there is consensus among economists and practitioners on the desirability of the independence of central banks. The agreement is that government should make medium term policies and the central bank should have full freedom in the methods it uses to implement those policies. In other words, the central bank should be policy-dependent but instrument-independent of government.

The medium or long term policy or policies the government dictates

¹ Recent developments in Australia have shown that since the Australian financial sector borrows significantly from the global financial market, the ability of the Reserve Bank of Australia to influence interest rate movements by playing in the domestic financial system is seriously limited.

to the central bank are enshrined in the relevant central bank legislation. Once the legislation comes to effect, the central bank independently designs its instruments to achieve the policy objective(s).

When government assigns the responsibility for a policy to a separate institution, it is in fact not shirking its responsibility. Normally, government determines policy through debate and discussion in Parliament. Debate and discussions are necessary in circumstances where there are tradeoffs and the adoption of a policy has adverse implications for other sectors. Debate and discussion in parliament assists in making a choice that the majority in parliament thinks is the right choice. If there is no choice to be made, no discussion is necessary. The current wisdom in having a central bank that is responsible for monetary policy and in most cases responsible for ensuring price stability stems from the fact in developed countries (and a belief in less developed countries) that in the medium term, the economy is at full employment while the price level can change depending on inflationary expectations. In the short run there is a tradeoff between unemployment and inflation but in the medium term there is no such tradeoff. As such, if government assigns the price stability objective to a separate institution, it is not shirking its responsibility. But the objective has to be a medium term objective not a short term objective.

It goes without saying that the objective of a central bank should be something that is achievable, over which the central bank has control, and is clear and concise.

The central bank in most countries is also assigned other functions. These include stability and soundness of the financial system (prudential regulation), issue and management of the currency, management of foreign exchange, banker, financial advisor, fiscal agent for Government, management of the payments system, and other related functions. These other functions can be assigned to institutions other than the central bank. In Australia, for example, the Australian Prudential Regulations Authority (APRA) looks after the prudential regulation of the financial sector. In addition, there is a distinct separation within the Reserve Bank of Australia with two Boards: the Reserve Bank Board and the Payments System Board, where the Reserve Bank Board is responsible for monetary and banking policy while the Payments System Board is given the power to control risk in the financial system, promote the efficiency of the payments system, and promote competition in the market for payments services.

For a country like Fiji where the economy is small and financial markets are not very deep or wide, the central bank can be responsible for

all the functions outlined above, with no need to assign any function to any other separate institution.

The objectives of the Reserve Bank of Fiji

The Reserve Bank of Fiji Act (1984) stipulates that the principal purposes of the RBF shall be:

- a. To regulate the issue of currency and the supply, availability and internal exchange of money;
- b. To promote monetary stability;
- c. To promote a sound financial structure; and
- d. To foster credit and exchange conditions conducive to the orderly and balanced economic development of the country.

These purposes are very wide and general: the only clear policy objective that comes out from these purposes is that of the stability of variables and institutions in the financial sector with a view to ensuring that the economy functions in an orderly and balanced manner. Such general and broad objectives can adversely affect the independence of the RBF as a result of the government in power interpreting these purposes differently. The objective needs to be clear and unambiguous.

Over the years, the RBF seems to have realized the difficulties it has faced as a result of the broad and general nature of the mandate the RBF Act has given it. The RBF has, for many years now, taken upon itself to set its own objective: maintaining low inflation. This objective is not clearly and unambiguously stipulated in the Act. Also, as argued later in this paper, the objective of price stability in Fiji is ill-conceived.

In its public statements, press releases, Quaterly Reviews, Annual reports, and other publications, the RBF talks about its 'twin objectives' of low inflation and adequate foreign reserves. Where a central bank is assigned the policy objective of price stability, it has to find methods or instruments to achieve that objective. The instrument chosen is another variable that is both very closely related to inflation and that the central bank can control easily. In the case of Fiji, the RBF operates on the belief that a significant proportion of inflation in Fiji is determined by foreign prices. As such if the exchange rate is kept fixed, the only significant variable that will determine the domestic price level will be foreign prices. If trading partners have effective policies to keep prices stable, Fiji can benefit from these effective policies. But to be able to keep the exchange rate fixed by playing in the foreign exchange market, the RBF needs to have adequate foreign reserves. As such, technically, the RBF

does not have twin objectives. The *de facto* policy objective is price stability and the instrument chosen to achieve it is a fixed exchange rate regime.

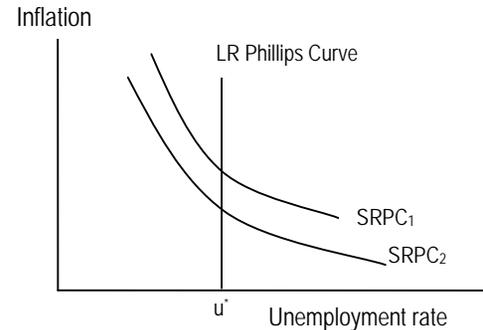
In an effort to understand the sources of inflation in Fiji, Dewan et al.(1999) find that 75 percent of inflation in Fiji is explained by import prices and about 25 percent by domestic labour costs. Narayan et al. (2006) investigated the relationship between inflation, budget deficit, and money supply and found that government deficits and money supply are key (Granger) causes of inflation in Fiji. However, Narayan et. al. (2006) maintain that a possible explanation for the effect of money supply on inflation could be the effect of import prices affecting inflation. They maintain that an increase in import prices could induce domestic money stock to rise in order to finance rising import prices. A similar reasoning could be applied to government deficits: higher import prices increase the government deficit and feed into inflation. Dulare (2005) found that in the long run, the price level in Fiji is determined almost exclusively by foreign (trading partner) prices, the nominal exchange rate, and inertia. The inertia factor can be seen as the effect of import prices on factors like the money stock, government deficit and domestic labour costs. Given the results of these studies, the RBF is justified in choosing the exchange rate as an instrument, or anchor, to achieve its objective of price stability.

Should Price Stability be the Objective of Monetary Policy?

If the RBF Act is reviewed and there is a separation between the objectives and functions of the RBF, there will be a need to think about what should be the objective of the RBF. Through its actions, the RBF seems to think that the objective should be price stability.

There are valid reasons for some governments to set a price stability objective for their central banks. The rationale for a price stability objective arises from the nature of the long run Phillips Curve. If the long run Phillips Curve is vertical at the natural rate of unemployment, a price stability policy objective makes sense. Consider the curve as in the following figure. In the short run, for an economy operating close to the natural rate of unemployment u^* , there is a trade-off between inflation and unemployment. The position of the short run Phillips Curve depends on inflationary expectations. The lower the inflationary expectations, the lower the position of the short run Phillips Curve. In the medium term, there is no such trade-off and the economy is at full employment with the Phillips Curve vertical. The only policy choice that has to be made for the medium term is where on the vertical Phillips Curve the economy should

be. It is, of course, desirable to have low inflation. Government makes this choice and then provides for this in the central bank legislation. Some governments might say prices must be stable (inflation low) while some might set inflation targets. After this choice is made, the responsibility can safely be given to a central bank to implement the policy. The role of the central bank, through its consistent action or policy rule, is to ensure that inflationary expectations are low.



The short run Phillips Curve can be transformed into the Aggregate Supply Curve and be written as

$$\pi_t = \alpha(Y^* - Y) + \beta\pi_{t-1}$$

where π is the inflation rate, Y^* potential output and Y the actual output.

If the Short Run Phillips Curve is downward sloping as in Figure 1, the Aggregate Supply Curve would be upward sloping and α would be positive.

Using a number of different measures of the output gap, ($Y^* - Y$), Goundar and Morling (2000) find that the output gap is a relatively poor predictor of inflation in Fiji. In other words, inflation in Fiji is not related to the output gap and therefore to the unemployment rate using most of the measures of the output gap.

However, using the structural vector autoregression method of estimating the output gap, Goundar and Morling find that there is a relationship between inflation and output but the coefficient α is negative suggesting that the Aggregate Supply Curve is downward sloping. The reason for this negative slope, they rightly maintain, is the dominance of

supply shocks in the economy.

Other studies investigating the relationship between inflation and economic activity find either very weak or no relationship between these variables. Dewan et. al. model the inflation process in Fiji using an unrestricted Error Correction Model (ECM). Inflation is modeled as dependent on changes in import prices, changes in the output gap, and changes in unit labour costs. Import prices and unit labour costs are found to have an effect on inflation in Fiji both in the short run and long run. The output gap has only short run effects. However, these results need to be interpreted with some reservations since the variables are not integrated of the same order.²

Gokal and Hanif (2004) investigate the relationship between inflation and real GDP growth using a correlation matrix between the variables and Granger “causality” tests. They find a weak and negative correlation between inflation and real GDP growth with causality running from economic growth to inflation. They conclude: ‘With the majority of Fiji’s inflation being imported, the influence of domestic factors (being unit labour costs and to a lesser extent the output gap) is limited’ (2004: 44)

Using an iterative 3SLS estimation in a simultaneous equation framework, Dulare (2005) finds that if domestic supply shocks like political upheavals, natural disasters and Changes in the Value Added Tax are set aside, the price level in Fiji is almost exclusively determined by the foreign price level, the exchange rate and inertia. The output gap has no effect on the price level.

It is evident from research undertaken largely from within the RBF that there is either no relationship or at best a weak or negative relationship between inflation and output (or the output gap). This implies that the short run aggregate supply curve is either horizontal or slightly downward sloping.

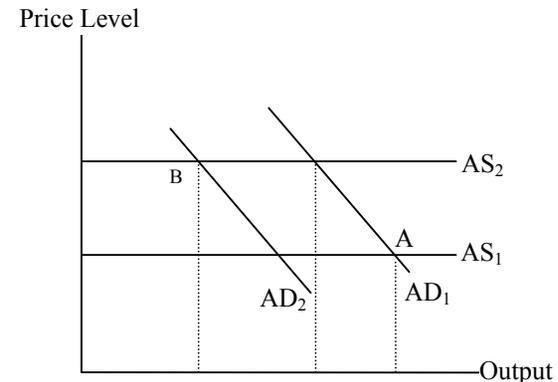
Given that, the short run aggregate supply is either flat or slightly negatively sloped, the objective of price stability is not only unachievable but leads to an adverse impact on economic activity. Consider Figure 2 below where the aggregate supply is horizontal. The economy is initially at point A. Suppose now that an adverse supply shock arising from higher import prices shifts the aggregate supply curve to AS₂. Prices rise and output falls. The RBF now tightens monetary policy in its attempt to reduce inflation in line with its self imposed objective. The tighter mone-

² Dewan, et. al. find that unit root tests reveal that the output gap is I(0), import prices appear to be I(1), and prices and unit labour costs are I(2). If variables are integrated of different orders, they cannot be cointegrated and an ECM becomes meaningless.

tary policy shifts the aggregate demand curve to AD₂ so that the economy reaches point B. Output falls further and to a significant extent while the price level has remained unchanged. If the aggregate supply is downward sloping, output would fall even further and prices would rise slightly.

This conclusion follows the demonstration by Beddies (1999) that if price stability is the objective in an economy characterized by supply shocks, there is greater variability in output. Chowdhury and Vidyattama commenting specifically on the Fiji economy are of the view that focus ‘on very low inflation rates and price stability when inflation is predominantly due to supply shocks has also contributed to excessive output volatility’ (2007: 11).

Figure 2



Monetary policy has also got to be informed of the fact that supply shock inflation implies less food on the table. One also needs to understand that the effect of a supply shock on unemployment implies no food on some tables. Monetary tightening in the face of an adverse supply shock ensures more tables with no food.

Conclusion

RBF is a public institution whose policies affect people. As such it has to be responsible, answerable and accountable to society through the objectives assigned to it by government through legislation. It has to be very serious about the effects its objectives and policy actions have on

people.

Various empirical studies concerning inflation and output (or output gap) have found results that indicate that the aggregate supply curve in Fiji is either horizontal or downward sloping. With an aggregate supply curve that is either extremely or perfectly elastic, a policy rule that tightens monetary policy in the face of shocks that originate predominantly from the supply side, leads to extremely large and adverse effects on employment and output.

As such, the RBF should reconsider its self imposed objective of price stability and re-interpret its interpretation of the RBF Act. The Fiji government needs to review the objectives in the RBF Act as well. The overall purpose of these re-interpretations and reviews should be a focus on output and employment/unemployment. Given that the level of poverty and unemployment in Fiji is high, the objective needs to be growth in output and employment not mere stability in these.

References

- Dewan E., S. Hussein and S. Morling (1999) 'Modelling Inflation Process in Fiji'. Economics Department Working Paper. Suva: Reserve Bank of Fiji.
- Dulare, C. (2005) *Monetary and Exchange Rate Policy in Fiji*, Lautoka: Fiji Institute of Applied Studies.
- Chowdhury, A. and Y. Vidyattama (2007) 'Macroeconomic Policies for Growth in Small Pacific Island Economies'. UNU-WIDER: Helsinki.
- Beddies, C. (1999) 'Monetary Policy and Public Finances: Inflation Targets in a New Perspective'. IMF Working Paper WP/99/26. Washington, DC: IMF.
- Rao, B. B. and R. Singh (2006) 'Monetary Policy in Fiji'. *Pacific Economic Bulletin* 21(2): 1-21.
- Gokal, V. and S. Hanif (2004) 'Relationship Between Inflation and Economic Growth'. Working Paper. Reserve Bank of Fiji.
- Goundar, K and S. Morling (2000) 'Measures of potential output in Fiji'. Working Paper. Reserve Bank of Fiji.
- Narayan P. K., Narayan, S. and A. D. Prasad (2006) 'Modeling the relationship between budget deficits, money supply and inflation in Fiji'. *Pacific Economic Bulletin* 21(2): 103-116.

Author:

Chandra P. Dulare is Dean of the School of Business at the University of Fiji, Saweni, Lautoka. Email: chandraD@unifiji.ac.fj