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**South Pacific**

*Monetary approach to Fiji's  
balance of payments (1975-90)*

*T.K. Jayaraman*

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**Key to symbols used in tables**

n.a.	Not applicable
..	Not available
-	Zero
.	Insignificant

**T.K. Jayaraman** is a senior economist at the Asian Development Bank, South Pacific Regional Office, Port Vila.

The views expressed in this paper are those of the author and do not represent those of his employer, the Asian Development Bank.

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**a**bstract

The paper applies the monetary approach to Fiji's balance of payments during 1975-90 and examines whether money played a role, either as a disturbance or an adjustment tool. Empirical investigation reveals that money indeed played a statistically significant role in the determination of deficits and surpluses in the balance of payments. These appear to have resulted from uncorrected excess supply in the stock of money and uncorrected excess demand for money. Further, the one to one negative relationship between domestic credit and the flow of international reserves has been established. The policy conclusion is that, given the limitations of the stable relationship between demand for money and relevant variables, including income and the price level, balance of payments disequilibria can be corrected through appropriate changes in domestic credit consistent with the demand for money.

# *m* onetary approach to Fiji's balance of payments (1975-90)

Over the last sixteen years, and particularly in the second half of the 1980s, Fiji's balance of payments experienced severe strains. Certain underlying strengths in the economy significantly contributed to successful management of the crises. The strains were primarily due to rapid growth in domestic demand for capital goods, including oil imports, as a result of increases in public sector expenditure during the late seventies and early eighties. Further, the period witnessed the weakening of commodity prices and a decline in tourism receipts and capital inflows following the political developments in the mid-eighties. The resilience of the economy in weathering these storms was remarkable. Increased efforts towards diversification of exports, including gold, fisheries and timber, together with measures for containing domestic demand, adjustments in exchange rates to make exports more competitive and the introduction of short-term foreign exchange control measures, enabled the country to gradually reduce the ratio of the current account deficit to GDP.

There is no doubt that Fiji's success in handling external payments is a classic example of the implementation of appropriate fiscal and exchange rate policies aimed at reducing domestic demand, switching demand from imports to domestic goods and encouraging exports. At the same time, the view of external payments as a monetary phenomenon, with money playing the key role in the long run, both as a disturbance and an adjustment in the balance of payments, is of interest to policy makers.

The objective of this paper is to apply the monetary approach to analysis of Fiji's balance of payments and to test the validity of the hypothesis that, under the fixed exchange rate system, changes in the nation's demand for money relative to its supply lead to changes in international reserves. A very brief summary of movements in Fiji's balance of payments and changes in international reserves over the sixteen year period between 1975 and 1990 is followed by the construction of a simple econometric model, the results of the empirical investigation and certain policy conclusions.

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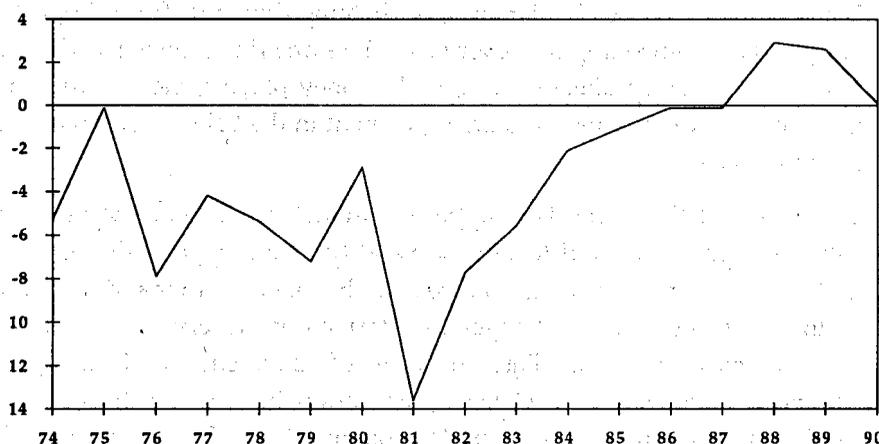
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## Balance of payments and international reserves of Fiji

### Balance of payments during 1975-85

Consideration of data on Fiji's balance of payments shows that, in the late seventies and early eighties, the annual current account deficit as a percentage of GDP ranged from 0.1 per cent in 1975 to 13.6 per cent in 1981, despite substantial earnings from tourism (Table 1 and Figure 1). This period was marked by high growth in domestic demand, mainly due to the sustained rate of growth in public expenditure. Due, however, to a decrease in the ratio of total trade in goods and services to GDP from nearly 95 per cent in the late seventies to 80 per cent in the mid-eighties (reflecting the decline in the openness of the economy), the trade deficit was further reduced. The reduction in the trade deficit combined with growth in tourism receipts, led to a reduction in the current account deficit to 0.1 per cent of GDP in the mid-eighties. During the second half of the eighties, concurrent with a slowdown in economic growth, there was a notable improvement in the current account. Due to a decline in the ratio of imports of goods and services to GDP and increases in net invisible receipts, the current account deficit became a current account surplus.

**Figure 1** Fiji's current account balance as a percentage of GDP, 1974-90



Source: South Pacific Economic and Social Database, *Fiji Statistical Compendium*, National Centre for Development Studies, The Australian National University, Canberra.

Table 1 Balance of payments: a summary (F\$ million)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Merchandise exports (fob)	122.8	101.1	144.3	146.9	202.6	278.8	240.8	236.4	221.5	249.9	238.5	281.2	389.6	493.8	595.5	730.3
Merchandise imports (fob)	190.3	204.8	241.0	255.2	340.4	393.0	465.7	411.2	428.9	422.8	440.3	417.9	404.1	564.2	736.1	873.1
Balance of trade	-67.5	-103.7	-96.7	-108.3	-137.8	-114.2	-224.9	-174.8	-07.4	-172.9	-201.8	-136.7	-14.5	-70.4	-140.6	-142.8
Freight and insurance on merchandise and other transaction (net)	-29.6	-31.7	-36.8	-41.3	-45.0	-52.5	-64.2	-55.5	-57.4	-57.3	-60.0	-55.9	-54.8	-83.7	-110.5	-129.7
Other transportation	14.5	20.5	20.1	20.5	27.0	44.3	45.6	48.6	54.7	67.0	59.3	42.7	26.5	45.8	81.1	91.0
Travel (net)	62.5	65.0	68.4	73.0	90.7	95.3	106.1	121.6	118.9	143.7	149.1	158.2	80.4	133.1	236.0	277.8
Investment income (net)	-7.1	-10.2	-8.1	-4.5	-13.5	-17.6	-16.0	-40.1	-35.6	-40.4	-43.6	-42.2	-45.6	-46.1	-54.3	-96.5
Government nie (net)	3.9	3.6	8.6	8.7	11.9	-2.1	2.1	5.9	13.3	22.1	31.0	28.2	34.3	42.0	20.9	24.8
Other (net)	10.1	5.7	11.0	11.0	11.6	-1.2	-7.9	-7.7	-24.1	-4.7	24.4	-12.9	-22.3	-19.6	-7.9	0.0
Goods and services balance	-4.8	-43.7	-27.0	-36.2	-70.7	-48.0	-159.2	-102.1	-89.4	-42.5	-41.6	-18.6	4.0	1.1	24.7	7.0
Unrequited transfers (net)	-0.4	-3.2	-1.0	-1.7	9.1	19.3	15.2	16.3	25.3	15.8	27.1	10.7	-10.8	43.1	22.8	4.0
Private (net)	-4.1	-4.4	-3.6	-3.4	-7.1	-3.6	-6.9	-2.8	-1.9	-4.2	-10.9	-6.0	-23.4	-5.1	-19.3	-33.0
Government (net)	3.7	1.2	2.7	1.7	16.2	22.9	22.1	19.1	27.2	20.1	38.0	16.7	12.6	48.2	42.1	37.0
Current account balance	-5.2	-46.9	-28.0	-37.9	-61.6	-28.7	-144.0	-85.8	-64.1	-26.7	-14.5	-7.9	-6.8	44.2	47.5	11.0
Capital account	20.6	23.0	33.1	-1.5	39.9	70.3	115.6	78.6	70.1	31.4	36.7	23.3	-62.6	93.2	1.2	91.5
Non-monetary capital	20.7	17.3	26.4	7.5	37.9	72.5	117.1	72.1	73.8	33.8	34.9	24.8	-53.2	88.8	10.7	86.5
Private	12.6	5.0	8.0	10.0	19.4	14.6	53.8	32.6	39.3	22.1	33.9	35.4	-22.2	79.2	62.6	147.6
Official	8.2	12.3	18.4	-2.5	18.5	57.9	63.3	39.5	34.6	11.7	1.0	-10.6	-31.0	9.6	-51.9	9.6
Monetary capital																
Commercial banks (net)	-0.1	5.7	6.7	-9.0	2.0	-2.2	-1.5	6.5	-3.7	-2.4	1.8	-1.5	-9.4	4.4	-9.5	5.0
Overall balance	15.4	-23.9	5.1	-39.4	-21.7	41.6	-28.4	-7.2	6.0	4.7	22.2	15.4	-69.4	137.4	48.7	102.5
Current account/GDP (%)	-0.1	-7.9	-4.2	-5.4	-7.2	-2.9	-13.6	-7.7	-5.6	-2.1	-1.1	-0.1	-0.1	2.9	2.6	0.1

Source: South Pacific Economic and Social Database, *Fiji Statistical Compendium*, National Centre for Development Studies, The Australian National University, Canberra; Current Economic Statistics April 1991, Bureau of Statistics, Suva, Fiji.

### **Balance of payments during 1986-90**

Despite the adverse effects of political developments in the mid-eighties, including a decline in tourism receipts and net capital inflows, the overall balance of payments and the current account were continuously in surplus between 1986 and 1990. Improvements in the balance of payments position were attributed to the two devaluations of the Fiji dollar against the basket of five currencies (the United States dollar, the Australian dollar, the New Zealand dollar, the United Kingdom pound sterling and the Japanese yen) to which it is pegged, and the implementation of selective foreign exchange controls.

The balance of trade showed a surplus in 1987 and in subsequent years. The current account recorded a surplus of about 3 per cent of GDP in 1988 and 1989 and a small surplus in 1990. The overall position of net foreign assets displayed a strong and increasing growth trend from 1985 onwards after fluctuating in the late seventies and early eighties. The sudden jump in the value of net foreign assets, from F\$194.6 million in 1987 to F\$327.7 million in 1988, was partly due to the devaluation of the domestic currency by 43 per cent over the previous year.

To sum up, improvements in the balance of payments position from the mid-eighties onwards, and the growth in net foreign assets, were primarily due to the expenditure-reducing policies and the decline in private sector activities following the political developments in the mid-eighties. Expenditure switching policies in terms of devaluation of the domestic currency were also important.

### **Monetary developments and balance of payments**

In terms of monetary developments over the sixteen year period 1975-90, prudential management contributed to general stability in the system, keeping inflation either close to, or below, inflation levels overseas and to growth in international reserves. Trends in broad money, net foreign assets, domestic credit and inflation rates are given (Table 2). Although the averages for 1975-80 and 1981-85 conceal large annual variations in monetary conditions during the corresponding periods, it is apparent that high rates of growth in domestic credit were responsible for modest rates of growth in net foreign assets. In 1986, growth in domestic credit was, compared with earlier years, much smaller and the growth in net foreign assets was substantial.

**Table 2 Trends in money supply, net foreign assets and domestic credit (average annual percentage change), 1975-90**

	1975-80	1981-85	1986	1987	1988	1989	1990
Broad money supply	21.7	9.5	16.7	3.6	20.6	10.4	24.5
Net foreign assets	10.9	2.7	44.8	2.6	68.2	1.0	18.9
Domestic credit	24.7	14.5	6.9	14.7	-7.4	32.2	17.8
Rate of inflation	11.2	5.1	1.8	5.6	11.8	6.2	8.1

Source: South Pacific Economic and Social Database, *Fiji Statistical Compendium*, National Centre for Development Studies, The Australian National University, Canberra.

In 1987, the economy experienced a big increase in domestic credit and there was a severe drain of bank liquidity resulting in a very small rate of growth in net foreign assets. Major measures were undertaken in the second half of 1987 to reduce domestic demand. This slowed the outflow of international reserves. As a result, there was a decline in domestic credit of -7.4 per cent in 1988 leading to a substantial rise in the growth of net foreign assets (68.2 per cent). This was followed by a sharp increase in money supply, by 20.6 per cent, and a rise in inflation by 11.8 per cent, part of which can be attributed to the effects of devaluation. In 1989, the attention of the Government was turned to absorption of excess liquidity in the system by the sale of Reserve Bank notes (Reserve Bank of Fiji 1990:15-20). As a result, domestic credit in 1989 increased by 32 per cent with credit to the Government increasing by nearly 100 per cent and domestic credit to the private sector increasing by only 31 per cent. Consequently, net foreign assets increased by one per cent over the previous year. The situation stabilized further in 1990 with a moderate increase in domestic credit and sizeable growth in net foreign assets accompanied by a big increase in money supply (Sturton and McGregor 1991).

## The model

### Monetary approach

The monetary approach postulates that the balance of payments problem, which is defined as the net increase or decrease in the level of a country's international reserves, is primarily a monetary phenomenon, representing disequilibrium in the market for money between actual and desired money balances. Therefore, analysis of the balance of payments problem necessitates use of the tools of monetary theory (Johnson 1977).

There are two important elements to the adjustment mechanism (Frankel and Johnson 1976). The first is that, in an open economy with a fixed exchange rate, there is a relationship between domestic money supply and the balance of payments. Total domestic money supply is determined within the system in that a balance of payments surplus leads to expansion of the monetary base and hence expansion of the domestic money supply, while a deficit leads to contraction of the monetary base and the money supply. The second element is that the demand for money is a stock demand and it is a stable function of a small number of variables.

Assuming equilibrium in the money market (with the stock demand for money equal to the supply of money), and equilibrium in external payments (with zero change in international reserves), an increase by the monetary authorities in the domestic component of the money supply leads to a position of total money stock exceeding the demand to hold it. The excess supply of money induces domestic residents to adjust the composition of their holdings to desired levels. The portfolio adjustment emphasized by the monetary approach to balance of payments is the exchange of money for foreign goods and assets. This increases the flow of expenditure on the current and capital accounts, which generates a balance of payments deficit. Such a deficit can be accommodated by running down international reserves, since the monetary authorities can sell foreign exchange and purchase domestic currency, with a view to maintaining the exchange rate. The loss of international reserves implies a fall in the domestic money supply and the process continues until all the excess supply of money has been eliminated, restoring stock equilibrium in the money market and equilibrium in the balance of payments.

Similarly, a contraction in the rate of growth of the domestic component of the money supply resulting in the total stock of money being less than the demand for it leads to the operation of the portfolio adjustment mechanism. Domestic residents exchange goods and assets for money through external payments, generating surpluses on the current and capital accounts. The balance of payments surplus thus expands international reserves and the total domestic money supply, once again restoring equilibrium both in the money market and in the balance of payments.

The monetary approach to the balance of payments recognizes that a balance of payments deficit or surplus could also be caused by changes in non-monetary variables. The impact of such variables is seen through their effect on the demand for, or supply of, money. For example, a fall in the rate of growth in an economy's output results in a fall in the rate of growth of its demand for money

and the consequent position of excess supply of money could generate a balance of payments deficit through portfolio adjustment. Thus, the adjustment process would eventually restore equilibrium in the money market and in the balance of payments (Pierce and Tysome 1985).

The main feature of the monetary approach is that long-run stock equilibrium in the money market ensures the long-run balance of payments equilibrium and therefore, balance of payments disequilibria are essentially short-run monetary disequilibria. Such disequilibria occur because of continuous creation of excess domestic credit by the monetary authorities, frustrating the operation of the automatic adjustment mechanism. The only measure available to restore equilibrium involves reduction of domestic credit.

Conventional balance of payment policy measures such as contraction of economic activity or reduction in public expenditure affect the balance of payments position through their effects on the demand for, and supply of, money. The policy of devaluation also amounts to increasing the demand for money. The consequent increase in domestic prices reduces the real value of the existing stock of money. This is equivalent to a contraction of the money stock by monetary authorities at an unchanged exchange rate. Such measures will have a transitory effect on balance of payments. A permanent effect is not assured until the only long-run remedy, reduction of the rate of domestic credit expansion, is undertaken (Frankel and Johnson 1976).

It is postulated that money supply in an economy is determined by the availability of international reserves signified by net foreign assets and the level of domestic credit created by the country's monetary system. This definition is symbolized by the following expression

$$M_s = NFA + DC \quad (1)$$

where

$$M_s = \text{money supply}$$

$$NFA = \text{net foreign assets}$$

$$DC = \text{domestic credit}$$

This stock equation can be transformed into a flow equation

$$\Delta M_s = \Delta NFA + \Delta DC \quad (2)$$

or

$$\Delta NFA = \Delta M_s - \Delta DC \quad (3)$$

where  $\Delta$  represents the change in the relevant variable.

Equation (3) defines the balance of payments. In equilibrium, money supply equates to money demanded.

$$M_s = M = M_d \quad (4)$$

where

$M_d$  = demand for money

$M$  = equilibrium stock of money

The demand for money is explained by a simple functional relationship along the lines of the Cambridge cash balance equation and the Keynesian theory of demand for money. Accordingly, the demand function for money can be written as follows

$$M_d = f(y, p, i) \quad (5)$$

where

$y$  = level of real domestic income

$p$  = price level

$i$  = rate of interest

The monetary theory states that there is a positive relationship between money held and income ( $\partial M_d / \partial y > 0$ ) and money held and the price level ( $\partial M_d / \partial p > 0$ ) and a negative relationship between money demanded and the interest rate ( $\partial M_d / \partial i < 0$ ). Manipulating Equations (3), (4) and (5), a straightforward algebraic relationship can be derived as follows

$$\Delta NFA = (\partial M / \partial y) \Delta y + (\partial M / \partial p) \Delta p + (\partial M / \partial i) \Delta i - \Delta DC \quad (6)$$

Equation (6) provides a direct explanation of the balance of payments. For empirical purposes, Equation (6) can be transformed into a linear regression model

$$\Delta NFA = a_1 + a_2 \Delta y + a_3 \Delta p + a_4 \Delta i - a_5 \Delta DC + u \quad (7)$$

where

$\Delta$  = change in the relevant variable

$a_1$  = intercept

$a_2$  = the first derivative of  $M$  with respect to income

$a_3$  = the first derivative of  $M$  with respect to price

$a_4$  = the first derivative of  $M$  with respect to the interest rate

$a_5$  = coefficient of domestic credit, with value equal to unity

$u$  = stochastic error term

Given the money stock, an increase in real income generates an increase in the demand for money. The increased demand for money also signifies excess supply of goods and other assets and could be satisfied through acquisition of money through the external payments process. This would result in an inflow of net foreign assets (Frankel and Johnson 1976:21). Hence, the sign of the coefficient  $a_2$  (of the variable, the first derivative of  $M$  with respect to income), is expected to be positive.

An increase in domestic prices, as a result of devaluation for example, will increase the demand for money. This will help absorb an excess supply of money and facilitate the inflow of international reserves. Similarly, an exogenous increase in domestic prices, say due to an increase in the price of oil imports, will lead to an increase in the demand for money and will have the same effect on balance of payments as the devaluation of the currency. Thus, the expected sign of the coefficient  $a_3$  (of the variable, the first derivative of  $M$  with respect to price), is positive.

An exogenous decrease in the interest rate will increase the speculative demand for money and, given a fixed money supply, the increased demand for money will result in a net inflow of international reserves and a balance of payments surplus. The expected sign of the coefficient  $a_4$  (of the variable, the first derivative of  $M$  with respect to the interest rate), is negative. The sign of the coefficient  $a_5$  (of the variable, domestic credit), is expected to be negative and the value of the estimated coefficient should be equal to unity.

## Results of empirical analysis

Data covering the sixteen year period, 1975-90 were utilized for testing the model defined in Equation 7 (Table 3). The data were drawn from the published data of the Government of Fiji.<sup>1</sup> Net foreign assets (NFA) are the total foreign assets of the commercial banks, the Reserve Bank of Fiji and the Government, less their respective foreign liabilities. Domestic credit (DC) is the sum of credit extended to the Government, official entities and the private sector. Real income and the price variable are GDP expressed in 1985 prices and the implicit GDP deflator (1985=100), respectively. As a broad range of financial assets does not exist in Fiji and the rate of interest was institutionally determined until the deregulation measures of the late eighties, the relevant opportunity cost of holding money is the expected rate of inflation. The rationale is that the only

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<sup>1</sup> These are compiled in the Statistical Compendium on Vanuatu, part of the South Pacific Economic and Social Database issued by the National Centre for Development Studies.

alternative to financial assets is real goods and services of which the public will hold more or less according to what it expects the rate of inflation to be (Sundararajan 1984:75-105). A host of interest rates were also tried. With the exception of the bank rate, the signs of the estimated coefficients of all interest rates were contrary to theoretical expectations. The actual inflation rate was employed as a proxy for the expected rate of inflation (Mansur 1989:316). In addition, a time trend was added while estimating the regression equation so as to isolate the influence of time on the explanatory variables.

**Table 3** Variables used in the analysis, 1974-90

	Net foreign assets (F\$ m)	GDP (1985 prices) (F\$ m)	GDP deflator (1985=100)	Bank rate (per cent)	Domestic credit (F\$ m)	Inflation (per cent)
1974	80.9	1153.8	39.0	6.4	83.1	14.5
1975	117.2	1153.3	48.8	6.3	86.6	13.1
1976	99.7	1173.7	53.1	5.5	120.5	11.4
1977	112.2	1132.9	58.3	5.5	140.7	7.0
1978	104.8	1153.3	60.9	5.6	172.0	6.1
1979	109.4	1292.2	65.9	6.5	223.9	7.8
1980	134.1	1220.5	77.4	7.5	231.5	14.5
1981	120.1	1346.5	78.4	8.8	279.4	11.2
1982	106.3	1332.1	83.6	9.5	333.7	7.0
1983	107.9	1279.2	89.3	10.2	381.5	6.7
1984	117.8	1386.5	92.0	11.0	412.6	5.3
1985	130.9	1316.0	100.0	11.0	441.7	4.4
1986	189.6	1424.9	102.6	8.0	472.0	1.8
1987	194.6	1338.4	108.0	11.0	541.3	5.6
1988	327.7	1349.1	114.0	11.0	501.2	11.8
1989	330.7	1517.3	120.0	8.0	662.8	6.2
1990	393.2	1577.5	130.0	8.0	780.8	8.1

**Sources:** South Pacific Economic and Social Database, *Fiji Statistical Compendium*, National Centre for Development Studies, The Australian National University, Canberra; International Monetary Fund, *International Financial Statistics Year Book*, 1991.

As the initial estimation of the linear regression equation indicated the presence of serial correlation, the Cochrane-Orcutt iterative procedure was adopted. The estimated equation, with convergence achieved after five iterations, is presented below.

$$\Delta\text{NFA} = -72.433 + 0.160\Delta y + 3.781\Delta p - 1.563\Delta i - 0.902\Delta\text{DC} + 9.964T$$

(-1.036) (2.834) (2.499) (-1.164) (-9.373) (1.753)

Number of observations :	16	Durbin-Watson statistic :	2.21
R <sup>2</sup> :	0.90	Adjusted R <sup>2</sup> :	0.84
Degrees of freedom :	10	F statistic :	10.93

(The figures in parantheses denote the calculated 't' values)

- \* Significant at 5 per cent level by one tailed test
- \*\* Significant at 10 per cent level by one tailed test
- \*\*\* Significant at 15 per cent level by one tailed test

The fitted equation emerged with the coefficients of all variables having the theoretically expected signs. The F-test confirmed the overall significance of the estimated regression as the computed value is larger than the critical value at the 5 per cent level of significance. The critical F(5,10) value at the 5 per cent level of significance is 3.33. Individually, the estimated coefficients of the three variables, namely change in GDP, change in price and change in domestic credit were found to be statistically significant at the 5 per cent level. The estimated coefficient of the change in the interest rate variable proxied by change in inflation, was significant at the 15 per cent level, whereas the estimated coefficient of the time trend was significant at the 10 per cent level. The critical t values at the 5, 10 and 15 per cent levels of significance by a one tailed test for 10 degrees of freedom are: 1.81, 1.37 and 1.09 respectively.

The value of the estimated coefficient of change in domestic credit (-0.90) is close to one and found to be statistically significant at the 5 per cent level. As the theoretically expected value is unity, the null hypothesis that the value of the coefficient was not significantly different from unity was tested. The computed t value for the test was found to be less then the critical value at the 5 per cent level and hence the null hypothesis could not be rejected.

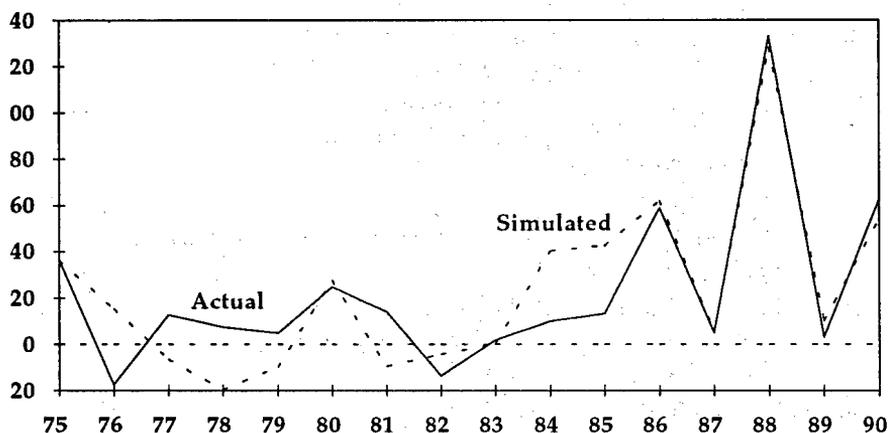
The model's predictive capability was tested by simulating the values of changes in net foreign assets over the period 1975-90. The predicted and actual magnitudes of changes in net foreign assets are given (Table 4; Figure 2).

**Table 4** Actual and predicted values of changes in net foreign assets (F\$ m), 1975-90

Year	Actual changes in NFA	Predicted changes in NFA
1975	36.30	35.99
1976	-17.50	15.19
1977	12.50	-6.44
1978	7.40	-19.77
1979	4.60	-9.71
1980	24.70	27.60
1981	14.00	-9.57
1982	-13.70	-4.24
1983	1.60	0.08
1984	9.90	40.33
1985	13.10	42.39
1986	58.70	61.84
1987	5.00	5.72
1988	133.10	128.23
1989	3.00	10.15
1990	62.50	53.76

Source: South Pacific Economic and Social Database, *Fiji Statistical Compendium*, National Centre for Development Studies, The Australian National University, Canberra.

Figure 2 Fiji: changes in net foreign assets (1975-90)



Source: South Pacific Economic and Social Database, *Fiji Statistical Compendium*, National Centre for Development Studies, The Australian National University, Canberra.

## Conclusions

The empirical investigation of the model reveals that the monetary approach to Fiji's balance of payments is indeed applicable. The statistical evidence confirms that money has indeed played a significant role in the determination of deficits and surpluses in the balance of payments. These have resulted from the uncorrected excess supply in the stock of money and uncorrected excess demand for money. The virtually one to one negative relationship between domestic credit and flow of international reserves has also been established.

The policy conclusions are clear. Given the limitations of the stable relationship between demand for money and variables including real income, the price level and the interest rate, balance of payments disequilibria can be corrected through reduction of domestic credit to a level consistent with demand for money. The conventional policy measures, including devaluation, import restrictions and export subsidization, can succeed only when domestic credit creation is well under control.

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