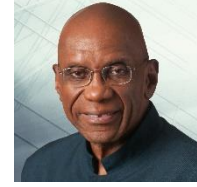




## Economic Letter February 2024



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### **Foreign Exchange is How We Pay for Imports**

Caribbean people are very aware that our countries need adequate supplies of foreign exchange to keep the economies ticking over, because so much of what we buy is imported. The focus on inflows of foreign currency is therefore not surprising. However, the image that is conjured up by this metaphor, of sheaths of US dollars being brought into our countries and deposited in vaults at our commercial banks, is completely misleading. As we all know, very little actual currency is used in international payments in any modern economy. The usual means of payment for imported items, hotel stays, airline fares and other cross-border purchases are cheques, drafts, credit and debit cards, online transfers, telephone apps, or similar arrangements and devices. These devices all issue instructions for the transfer of value from a purchaser's bank account to the bank account of a vendor. No currency of any kind is involved.

Visitors to the Caribbean typically pay for their accommodation using a credit or debit card. When the card is read, a digital message is sent to the visitor's card account with an instruction to deduct the value of the payment, and a message goes to the hotel, guest house or Airbnb which provides their accommodation, crediting that value to them. This process is completed in real time, via internet, and it involves no currency of any kind, or any transfer of money. It is immaterial where and when the payment

takes place. The process, and the resulting transfer of value, is exactly the same for an all-inclusive prepaid vacation as it is for a card payment that is made at the checkout desk of a hotel. Only the timing differs. The values are almost always expressed in US dollars, but they might just as well be expressed in local currency, because the banks where the visitor's and hotel's accounts are held will always have a value for the local currency in terms of US dollars at the instant that the credit card is read. The reason for the choice of the US dollar for valuing transactions is the obvious one, that the US dollar is the universal standard of value. The seller always prefers US dollars, which can be spent anywhere in the world, to local currency, whose value is uncertain anywhere except in the local economy.

Foreign exchange is vital because it is what the Caribbean uses to buy imports, and imports are the means by which we maintain the quality of our lives and improve our standard of living. It is the purchasing power of the foreign currency we earn or borrow that matters, not where or when the transfer of value into locally owned bank accounts takes place. The local economy benefits, not from the currency, but from the imports we can afford as a result of the international spending power that foreign currency provides. It follows that the preoccupation with foreign currency actually reaching Caribbean shores is entirely misplaced. What foreign currency does find its way into the Caribbean provides a benefit only when we use it to fund our holiday in Panama, or our trip to Trinidad Carnival or to the Big Apple. We may hold on to foreign currency, but we will do so only because we expect to put it to use in the future, in effect postponing the expected benefit. And as for imports, it is hard to think of anything that can be paid for with notes and coins.

We should look to the balance of external payments for an indicator of the benefit the country derives from foreign currency supply. When an increase in foreign currency supply provides more spending power, we expect to see an increase in imports, because every purchase involves an imported element. Foreign currency will remain overseas only if it is surplus to the country's import needs. There is one exception, that is, foreign currency set aside as reserves to protect the value of local currency. In a country like Panama where there is no local currency, or like Bermuda, where there is no central bank, there is no need for reserves. The full amount of foreign currency supply is available for the purchase of imports. If anything remains after import needs are fully met, banks will retain the surplus in accounts with foreign banks that are for value that is owned by local companies, individuals or the local banks. In these circumstances, the local economy benefits from foreign earnings and borrowing to the full extent that residents desire, and what remains is the amount they are content to put aside for future use.

We must be careful to distinguish between foreign currency supply, that is, earnings and borrowing, and foreign currency reserves, which are amounts set aside to protect the value of domestic currency. (The reserves are often referred to as foreign exchange reserves; the terms "currency" and "exchange" are used interchangeably.) Increases in foreign currency supply are welcome, because they increase spending power and can be used to invest in new productive capacity such as hotels and electricity supply. Foreign exchange reserves, on the other hand, should only be held to the minimum that is considered necessary, because it is harmful to sacrifice imports that might yield benefits to the domestic economy for the dubious privilege of issuing a domestic currency.

To sum up. The array of products and services we obtain from abroad are what enables the quality of life and standard of living enjoyed in the Caribbean. The foreign currency we earn and borrow does not come

to the Caribbean, physically or virtually; what comes to us in the region is the purchases we make with that foreign currency. It doesn't matter where the purchasers in the Caribbean or the sellers abroad do their banking, so long as, at the end of the day, full and accurate values are recorded for all transactions and for the delivery of all purchases. The balance of payments will provide the record of the value of imports and foreign services that residents have been able to afford with the foreign currency supply that was received.

*My Economic Letters may be found under "[Commentary](#)" at [DeLisleWorrell.com](http://DeLisleWorrell.com).*