Foreign Reserves - Living in Need With Money in the Bank

Caribbean countries find it necessary to hold large reserves of foreign currency in order to protect the value of their domestic currency against the possibility of devaluation. Experience has taught us that devaluation makes everyone who earns local currency income worse off, with no compensating benefit. Hotel and export prices are unaffected by the devaluation, so revenues from tourism and exports are unchanged.

However, foreign reserves are only for demonstration purposes; they can never actually be used to sustain the value of the local currency, except for very short periods and in small amounts. Should the reserve level decline significantly, no matter how high it may be, people will begin to worry that a devaluation may be imminent. Swift and convincing action has to be taken to restore confidence that the loss of foreign reserves will soon be arrested. That action usually involves a cut in government spending and borrowing.

There is therefore no benefit from holding excessively high levels of foreign reserves. Reserves should be just sufficient to satisfy import needs for as long as it takes for any necessary adjustment in government spending to take effect.

Accumulating foreign reserves in excess of amounts to tide the economy over the short term comes at a considerable cost. The countries of the Caribbean Community (CARICOM) are reported to hold a total of US$18 billion in foreign reserves; the Dominican Republic alone adds another US$14 billion, for a total of US$32 billion of foreign reserves for the Caribbean as a whole (excluding Cuba). This compares with the total investment reported for the Caribbean of US$3.5 billion in 2023, in the most recent report from the UN Economic Commission for Latin America and the Caribbean. The accumulated foreign funding that Caribbean countries have placed, mainly on deposit with the Federal Reserve Bank of New York and for the purchase of US Government debt, is almost ten times the total of private and public investment in the countries themselves.

There is not much that may be done about this anomalous situation, either through private sector initiatives or by governments. As far as private investment is concerned, the factors that are key to a revival are the competitiveness of potential investment projects, the efficiency of the domestic regulatory and public administrative arrangements and the degree of uncertainty in product and financial markets. If and when these circumstances improve, private investment will increase from its current low level across the Caribbean.

The foreign reserves are owned by governments, and in principle they could be used to help finance hospitals, schools, ports and airports, roads, public utilities, vehicles and equipment, communications infrastructure, or any of the many investment priorities identified by government. However, Caribbean governments lack the capacity to implement public investment projects at a faster pace than is actually the case. Over the past four decades governments have been provided with a wealth of technical assistance in efforts to improve implementation capacity, with little evidence of success.

The fact that the Caribbean contributes so much of scarce foreign currency to financing the US Government deficit when the region's needs for public sector investment remain so extensive, is a manifestation of the incapacity of the Caribbean public services. This anomaly has to be addressed by a reform of the public sector whose results can be measured by the efficient design and timely completion of a public investment strategy for the development of Caribbean economies.