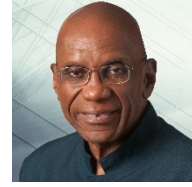




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Savings, Housing and Development in the Small Open Economy

It has been observed that households everywhere in the Caribbean aspire to own their own homes. This comes as no surprise because home ownership is the most secure investment individuals can make everywhere in the region. The benefit earned by not paying rent usually exceeds the interest earnings on alternative uses of savings such as government bonds and equities. In addition, property values will invariably catch up with inflation, even if that process takes some time. When the mortgage which funds most house purchases is fully repaid, the owners have an asset whose value exceeds their total debt servicing costs by a considerable amount, in most cases. Reductions in interest rates, tax incentives and other policies may be helpful in stimulating the housing market in large economies. This not only creates jobs and economic activity, it improves the quality of life of the population and makes the economy more attractive to potential investors.

Unfortunately, small economies cannot jump start development through the housing market in this way. The reason is that new housing generates a demand for imports of construction materials, equipment, furniture, furnishings and fixtures, fuels and other inputs, none of which are produced locally with only local materials. Housing in the small economy, like any other investment, has to be financed from foreign currency sources, not by local savings. None of the products of Caribbean countries - tourism services,

sugar, coffee, pharmaceuticals, clothing or crude oil - is used in building houses. The local currency savings used to provide mortgages for new housing will generate a demand for foreign currency as soon as construction gets underway. Construction can proceed only as quickly as earnings increase from tourism, exports or foreign investment. Otherwise, the central bank's foreign reserves will fall as banks buy foreign currency to make up the shortfall caused by the increased construction.

A similar limitation applies to public housing in small economies. In countries large and small, governments prioritise affordable housing for persons whose incomes are too low to cover rental costs for adequate housing. In large economies government may borrow on local currency markets to fund the construction of affordable housing. However, the government of a small economy will need to source funding from abroad if it is to avoid an erosion of foreign reserves.

The housing market serves to illustrate the fallacy of the popular notion that Caribbean countries should provide incentives for saving in order to stimulate investment and growth. Domestic savings will cover only a small percentage of the cost of any investment because the bulk of the equipment, materials and supplies for investment are imported. Economists regularly bemoan the low savings rates that are reported in the national accounts of countries in the region. Policymakers devise incentives intended to stimulate additional saving. They are all to no avail because the local currency funding which savers provide has to be used to purchase foreign currency in order to make the investment possible. When the national accounts are computed, it is the foreign currency that will be measured because that is what balances the purchases of imports with the sources from which the imports were financed.

Desirable though it may be, to improve the quality of life and attractiveness to investors, domestic home construction cannot be an engine of growth in a small open economy. That is true whether the impetus comes from government or banks and mortgage lenders. Incentives to promote home buying and the provision of affordable housing should be national priorities, but the extent of housing expansion will depend on the foreign currency provided by the growth of tourist revenues, export receipts, foreign investment, remittances and other foreign currency inflows.

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