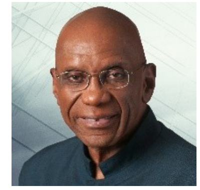

Economic Letter August 2022

Illustration: Marc Hollingsworth

Imports Are the Reason Small Economies Need Foreign Exchange

The small economy earns foreign exchange from tourists, from exports and from other sources, for the purpose of buying imports, in much the same way as individuals seek paid employment so as to buy household necessities. In a subsistence economy every family or group has to fend for itself, depending only on what it can produce with its own resources; the quality of life is poor. A family whose members gain employment that provides a wage sufficient to buy the much wider range of products that are needed for a modern standard of living will enjoy a far superior quality of life. It's much the same for Caribbean countries and other small economies. The reason these countries need to achieve competitive standards of production and service in tourism and exporting, is so that they have the wherewithal to buy imports. If imports are reduced significantly or for an extended period, the standard of living will fall. Hence the need to earn foreign exchange. Importing is as essential for the prosperity of the small nation as supermarket shopping is for the household.

Upwards of ninety percent of the items listed in the United Nations *Standard International Trade Classification* are items which Caribbean countries do not produce. Of the remainder, local products are invariably less affordable than imported items; people will willingly buy local if the domestic product is of comparable quality at a competitive price. If it is necessary to protect local products by high tariffs or bans on imports, that is clear evidence that domestic producers are not as efficient as their foreign competitors. Shielding inefficient local producers comes at the expense of local consumers, who have to pay higher prices than they would have had to, in the absence of the barriers to imports.

The argument that imported items are of lesser quality and must therefore be kept out is difficult to justify. If imports are of lesser quality people who can afford the better-quality local products will buy them despite their higher price; nobody will buy a shoddy import if they can afford a comparable local product of good quality. The reality is that, even for the limited selection of imports that are produced locally, few can attain a scale and sophistication of production to compete with the prices of imports. The best route to success for local producers is to target sales to discerning consumers and for special occasions, where they can secure customers for fresh produce and items of high value, because people will splurge a little for the special occasion.

Foreign currency that flows into the small economy never stays in the economy, except for a small percentage that is held in cash, mainly US dollars. The inflows that are made by way of transfers to banks and branches in the country are sold to importers and others needing to make payments in foreign currency. Any surplus that remains is sold to other banks or to the central bank. Any surplus that is left to the banking system as a whole is placed with the US Federal Reserve Bank of New York, if it ends up with the central bank. Balances that remain with the commercial banks are placed on deposit with their correspondents in the US. Apart from actual US currency notes, no foreign currency stays in the country.

Just as every prudent household builds a reserve of savings, to offer some insurance against the vicissitudes of life, the prudent government maintains a modest reserve of foreign currency to provide breathing room in case of an unexpected fall-off in foreign earnings. Foreign reserves should be sufficient to allow government to avoid an abrupt fall in the availability of foreign exchange when a pandemic hits, or when import prices skyrocket. Imports will have to be cut if the foreign currency losses persist, because the foreign reserves will be exhausted if they are not; foreign reserves are nothing more than a temporary fix.

Imports are what supports the livelihoods and lifestyles of the people who live in small countries. The foreign exchange small economies earn is for the purchase of imports; the foreign exchange they borrow should be for investment that will increase the capacity to earn foreign exchange, either directly via hotels and factories, or indirectly through the upgrade of ports, roads, airports and hospitals. The foreign currency reserved with the New York Fed should be no more than is needed to cover the period of adjusting to possible reduced foreign earnings or reduced spending power because of import price inflation.

Earlier Economic Letters may be found on [my website].