More Foreign Reserves are not Necessarily Better

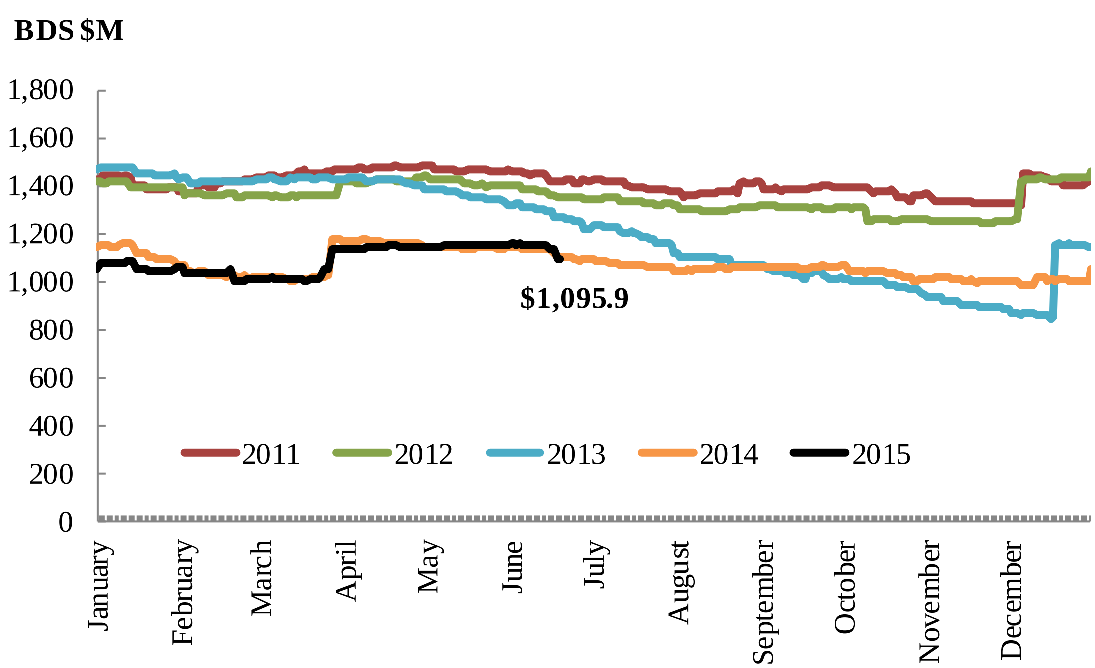
In April this year, when we were in Washington for the Spring Meetings of the IMF and World Bank, I read of the death of an ordinary American - he may have been a postal worker or employee of an express delivery service - who left a fortune of US$8 million in stocks and bonds, that he had accumulated over a lifetime of careful investing. Ever so often we hear similar stories of persons of modest means who live lives of relative penury, and are able to accumulate surprising wealth. While we may all admire their fortitude, most of us would, in similar circumstances, choose to spend some of those gains to enrich our own lives, rather than accumulate wealth for its own sake.

It is much the same with a country's foreign exchange reserves. Foreign reserves held in US Government treasury securities and other highly rated US$ denominated paper, are in effect loans made by Barbados to the Government of the US and to the other American issuers whose bonds we hold. The Central Bank of Barbados makes these investments abroad out of the foreign exchange that is earned from exports and tourism, as well as the proceeds of any foreign borrowings that are not immediately utilised.

Why would a country like Barbados, which always needs foreign exchange to boost investment and growth, choose to lend some of those funds back to the US instead? The reason is evident in our experience in 2013. From May of that year we noticed a persistent decline in the Central Bank's foreign exchange reserves, indicating that the level of spending on imports was too high, relative to the inflows of foreign exchange. We knew by the end of the month that a government budget would be needed to dampen imports, but the process of consultation leading up to that budget took three months. In the meanwhile, the "excess" of imports was financed out of foreign reserves. That is the essential purpose of foreign reserves: to allow normal trade to continue during the period of adjustment, while fundamental changes are being made to bring foreign exchange inflows and outflows into balance.

International Reserves 2011-2015

as at June 19, 2015



What level of reserves do you need to provide adequate breathing space in all circumstances? Forty years ago I completed my Ph. D thesis on precisely this question, using Jamaica as my example. It is, in essence, a question of how much insurance the country should buy. The insurance premium is the amount you add to foreign reserves - Barbados' loan to the US Government - every year. The cost of that premium, what economists call an "opportunity cost", is the local investment you could have financed instead. The maximum potential benefit is the amount of imports you can cover with the total accumulated reserves. Every country should balance cost and benefit in determining what level of reserves is adequate.

In practice, we have found that a reserve level equivalent to 12 weeks of imports is ample for Barbados' needs. In 2013 fiscal actions to restore the foreign balance took seven months to become fully effective, and in that time the country lost foreign reserves equivalent to no more than about three weeks of imports, of the 16 weeks equivalent that we started with. Foreign reserves should be viewed as a "top up" to the supply of foreign exchange. Even in difficult times most imports are financed by normal inflows of foreign exchange for tourism, international business and finance, physical exports and capital inflows, for the most part. In a difficult year like 2013, 94 percent of imports were financed from these sources, and only six percent from the draw-down of foreign reserves.

To sum up: countries should maintain foreign exchange reserves sufficient to allow time to adjust to the vagaries of international markets, so that banks and traders do not become apprehensive about the value of the currency. Beyond that modest level, foreign reserves are a drag on economic growth, employing foreign exchange in lending abroad resources which might be better employed in the finance of investment at home.

If there's a lesson to be learnt from the elderly postal worker/delivery man, it's that while it is important to have something in reserve, you should not deprive yourself of things everyone aspires to, in order to store away what is of no real benefit to you.

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