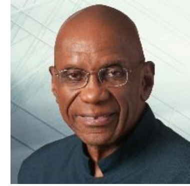
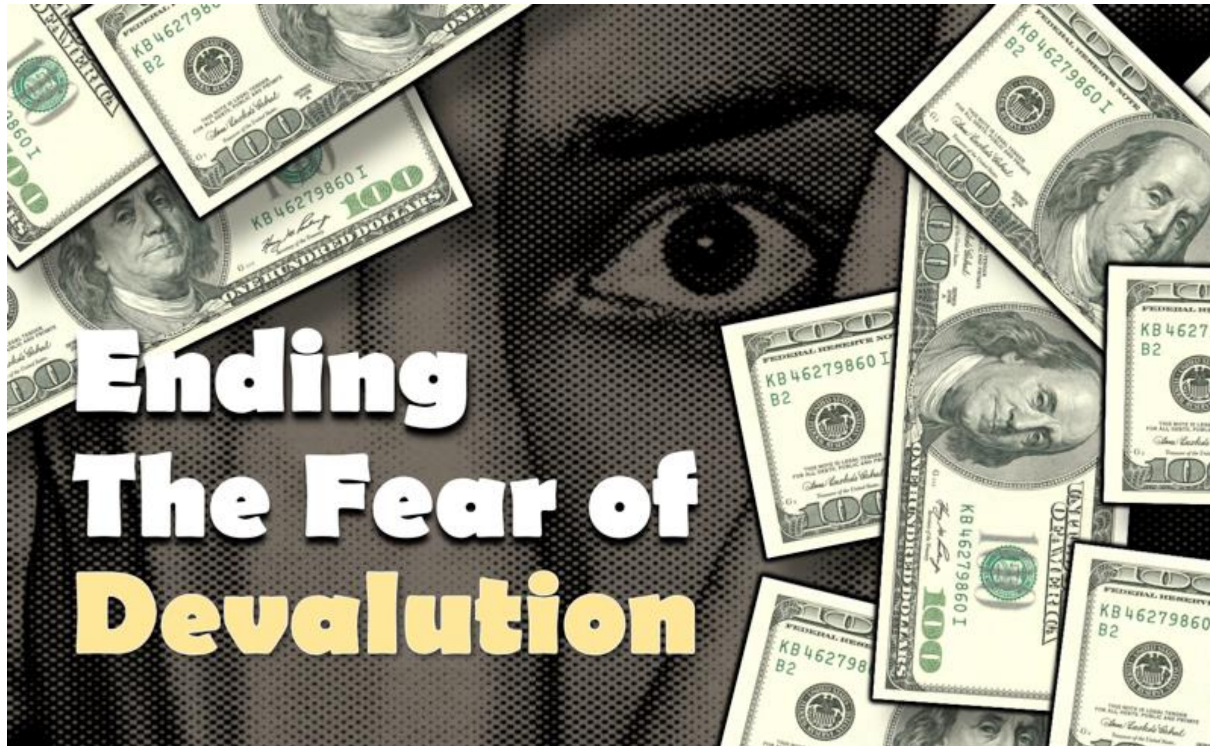


Economic Letter March 2024



Marc Hollingsworth, Media Support International

Ending the Fear of Devaluation

The populations of almost all the countries of Central America and the Caribbean live with an abiding risk of devaluation of the international value of their incomes, their homes, their bank balances and all their real and financial property. The exceptions, those who live free of any apprehension on this account, are the residents of Panama and El Salvador, and anyone else whose income and property is denominated in US dollars. For better or worse, the US dollar is the world's common standard of value, in much the same way as the Greenwich mean is the world's common standard reference for the time of the day. Panama and El Salvador have no domestic currency; all incomes and all wealth is denominated in US dollars. The prices of oil, food or other internationally traded goods may rise, reducing the spending power of their incomes, but the effects will not be aggravated, as might be the case elsewhere in the region, by devaluation of a local currency. In the absence of global effects to which all nations are subject, there is no risk to their net worth or the purchasing power of their incomes, specific to their countries.

The countries of the region, and indeed most countries worldwide whose currencies are at risk of loss of value internationally, are now able to eliminate exchange risk completely by replacing domestic currencies with the US dollar, the euro or whatever international money the population chooses. All that is needed is for the country's central bank to use US dollar balances held in reserve at the Federal Reserve Bank of New York to retire all the local currency notes and coins that are outstanding at the current market exchange rate for the local currency. Most central banks hold foreign reserves well in excess of what would be required for that exchange.

There is no call on foreign reserves to redeem the local currency deposits at commercial banks. The depositors will be more than happy to have their balances revalued from local currency to US dollars at whatever is the prevailing exchange rate, and to leave the US dollar balances on their bank accounts. The banks will be able to accommodate this change, by converting all the credit they have offered to customers to its value in US dollars at the same market rate. As both loans and deposits are converted to US dollar equivalents simultaneously, there is no material change in any bank's balance sheet.

The main impact of the complete retirement of domestic currency would be on central bank financing of public sector deficits. The central bank would no longer be able to offer credit to the public sector without regard to the total amount of financing made available to the central bank itself by commercial banks. A central bank that issues a local currency faces no such constraint; it can honour any cheque which is written on the Treasury account at the central bank. In contrast, if the cheque is in US dollars, because no local currency exists, the central bank can honour that cheque only to the extent of its own US dollar resources.

This limitation may appear to be a surrender of autonomy, but it is actually a blessing in disguise. The reason is that all expenditure in the small economies of the Central American and Caribbean region result ultimately in a need for imported fuel, consumer items, inputs such as flour and chicken feed and other imported items. Because of this, any amount of additional local currency credit the central bank advances to the public sector will eventually cause a loss in the foreign reserves held by the bank when that money works its way through the system and the time comes to order imports. The implication is that the central bank should lend only small amounts, and for short periods, to avoid putting serious pressure on the foreign reserves, with the risk of a devaluation of the domestic currency.

The problem with an own currency is that there is no way to guarantee that government will respect the limits of prudence in its borrowing from the central bank at all times and in all circumstances. The temptation to excessive borrowing is particularly strong in the lead-up to general elections. To complicate matters, it may not be clear to everyone where the limits to prudent borrowing lie. In these circumstances, banks and trading companies may reduce their foreign currency exposures out of an abundance of caution. They shift all cash balances into foreign currency, and replace foreign currency borrowing with loans in domestic currency, a process which aggravates the perceived shortage of foreign currency.

In small open economies, the benefit of having a local currency appears to be outweighed by the devaluation risks. A majority of small economies, in the Caribbean, Central America and elsewhere have failed in their attempts to support the international purchasing power of their currencies. Even those that have succeeded in avoiding large devaluations are subject to exchange rate crises of some severity from time to time. The risk of devaluation never goes away. What is more, the country pays a high price in holdings of foreign reserves to provide some insurance against that risk. Arguably, this money would be better employed in financing infrastructure, health, education or other public sector priorities.

The benefit of a domestic currency, the ability to provide limited and temporary financing of public sector expenditure, appears trivial by comparison with the ever-present risk of devaluation. What is more, limited short term credit is available to governments with sound credit, even in countries with no currency of their own. Such accommodation may be had from commercial banks and from the central bank at market rates. This is not new money, and it does not increase the total national spending power; furthermore, it is in international currency and may therefore be used to purchase whatever is needed, both of domestic goods or imports.

The belief that the issue of a domestic currency is a beneficial exercise of national sovereignty is an illusion. Instead small economies may rid themselves of the fear of loss of value of their wealth and

incomes, and economise on the balances held in accounts at the Federal Reserve Bank of New York by using the international money as their domestic currency. For the countries of Central America and the Caribbean, and for many other countries around the world, the international money happens to be the US dollar.

My Economic Letters may be found under "Commentary" at DeLisleWorrell.com.