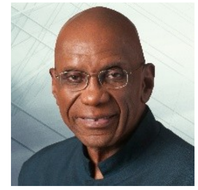


Economic Letter January 2023

Foreign Currency - What Comes in, Goes Back Out

In Chapter One of my new book, *Development and Stabilization in Small Open Economies*, there is a diagram (shown below) which represents the national income of a fictional Caribbean country, Isla Caribe, a tourist economy with a domestic currency called the peso. The peso trades at ten pesos to a US dollar. In a typical year, earnings from tourism, plus foreign investment and foreign loans, bring in US$10 billion in foreign currency. That provides 100 billion pesos of income for hotel and restaurant workers, taxi drivers, workers at spas, health clubs, activities, nightclubs and attractions, as well as for the water, electricity, security, cleaning and waste disposal services used by all these activities. The foreign currency inflow also pays for hotel and other foreign funded construction, and provides the profits earned by companies supplying all these services. All these incomes set off secondary effects, through spending in supermarkets, purchases of fuel, banking and insurance services, and the payments of taxes to fund education, health, the police and other public services.

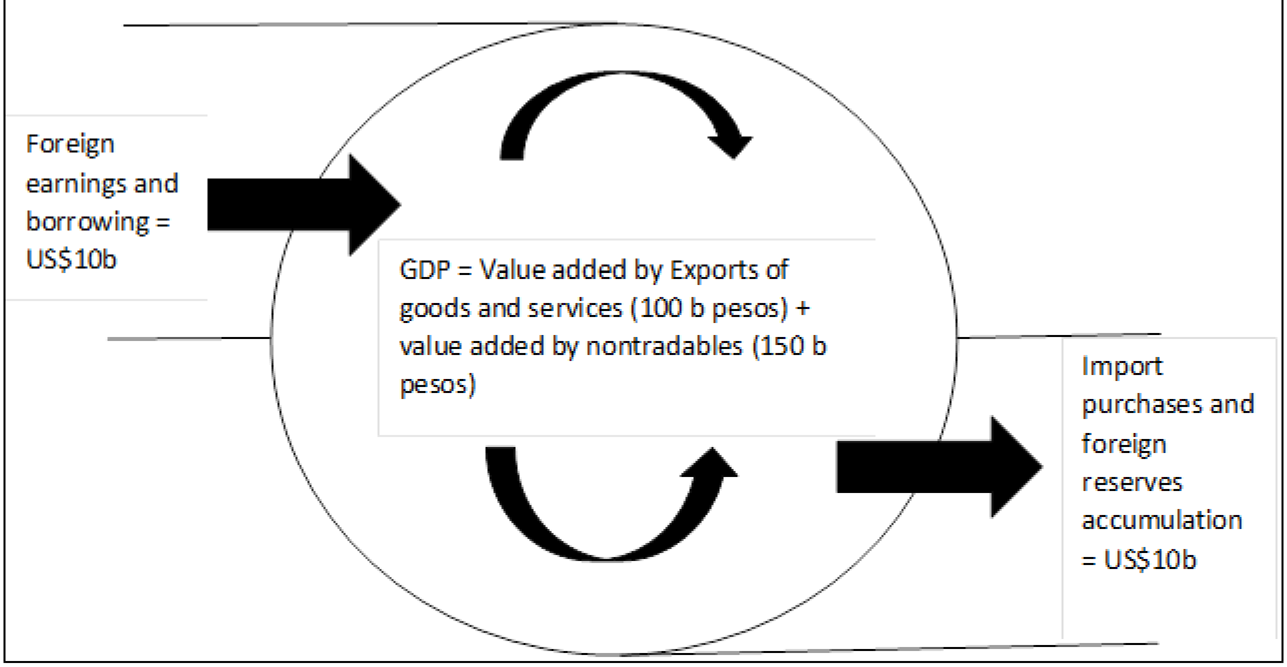
All this domestic circulation adds another 150 billion pesos to the 100 billion pesos that was earned from tourist activity, foreign investment and foreign borrowing, for a total national income of 250 billion pesos. Notice however, that this national spending generates a need for payments for imports, to buy fuel, to restock supermarket shelves, to purchase computers, cell phones, motor cars and buses, trucks, office equipment, electrical and plumbing supplies, medicines, animal feed, broiler chicks, steel and construction materials, and all the thousands of items without which the society cannot function.

It is obvious that the government and residents of Isla Caribe are limited in the amount of imports they can buy, by the amount of foreign currency they have earned or borrowed. That is the first home truth of the small open economy: the national income is limited by the amount of foreign currency available, because the income is used to purchase necessary imports. Government may create more pesos by issuing cheques in excess of the amount of tax receipts, but the ultimate recipients of this peso income will be unable to buy any additional imports unless and until more foreign currency is available.

A second home truth is that all the foreign currency that comes into the country goes back out again. Government and residents cannot spend more foreign currency than is available, but they may choose to spend less. That may or may not be a prudent thing to do. If any foreign currency remains with commercial banks or with the central bank after import requirements are fully satisfied, that money is invested abroad, mainly in the US, the world's richest country. Foreign currency held in reserve by the central bank is placed on deposit with the Federal Reserve Bank of New York and invested in US government bonds. Any net foreign balances at commercial banks are placed on deposit with foreign branches and correspondents. These balances all remain in the ownership of the residents of Isla Caribe, of course, but they are monies which will have been lent abroad. All the foreign currency that comes in, goes back out, either to buy imports or to be invested abroad.

It follows that frequently-expressed concerns about foreign currency "leaking" out of the country are unfounded and based on a misunderstanding of the way that small economies improve the living standards of their residents. Small countries are expected to spend the foreign currency they earn, in much the same way that the family spends the income it earns, rather than hoard it under a mattress. Similarly, it is wise for a small country to put aside some foreign earnings in reserves to take care of unexpected challenges, just as a household should aim to set aside savings for a rainy day. But just as it makes little sense to save to the extent of foregoing necessities, it is unwise of a country to accumulate reserves at the expense of imports for investment projects and consumption that enriches the livelihood of the population.

Figure 1.1 The Small Open Economy



Further information on *Development and Stabilization in Small Open Economies* may be found at this link, where you may also find information on the date of issue, availability and pricing.

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