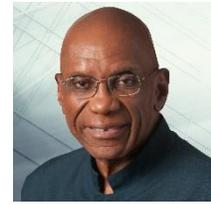




Working Paper



The Time Has Come to Permanently Retire All Our Caribbean Currencies

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Abstract

The currencies of Caribbean countries have now outlived their usefulness, and have become a liability. They were devised at a time when most payments were made using notes and coin, issued in distant metropolitan centres. Scarcity of the means of payment was a severe hindrance to commerce. In response Currency Boards were set up, to issue local currency as needed in the colonies. The system worked well because the local currency issue was backed by an equivalent value of Sterling, in a global system of fixed exchange rates. In contrast, nowadays payments are made mostly by electronic communication, credit and debit cards, cheques and drafts, with settlement over digitized bank accounts. In today's world an own currency has become a liability for small economies, limiting access to international goods and services, exposing residents to risks of currency devaluation and inflation, eroding the value of domestic savings, increasing economic inequalities, providing a tool for unproductive government spending, and diverting attention from the need to increase productivity and enhance international competitiveness.

Keywords

Dollarisation; exchange rate; fixed exchange rate; foreign currency; currency board; open economy.

JEL Classification

F31, F32

Introduction

Those of you who are fans of Netflix may have come across a mystery series entitled “Hinterland”, which is set in the Welsh countryside. Several of the characters speak the Welsh language, *y Gymraeg*, and the series has a Welsh title, *Y Gwyll*. Had this series been issued only with its Welsh title, and had the Welsh dialogue not been subtitled, we would never have heard of it, and it would never have appeared on Netflix. Having your own native language is a source of pride, but if it is the only language you speak, your life chances are severely limited. In contrast, native English speakers in Trinidad or Barbados have unlimited possibilities for education, travel and migration, and an infinitely rich universe of information and communication.

Having your own currency is rather like having your own language: if our people only have access to Trinidad-Tobago dollars or Barbados dollars, there is very little economic activity of any kind that they can undertake. Even basic subsistence farming requires forks and hoes, which use metals that are not found in these parts. The production of every product or service in the local economy involves the use of fuels and other imported inputs, which must ultimately be sourced in foreign currency. In addition, the great majority of consumer goods are imported, and those which are not, are produced with the use of imported inputs. If all we have is local currency, we can neither produce nor consume. Small modern economies are fuelled by foreign exchange: they can sustain the quality of life for residents only by maintaining the inflow of foreign currency; and they grow the economy by increasing the amount of foreign currency they earn or borrow.

Currencies served a crucial purpose when they were first introduced ...

Why then do we have local currencies, if what matters for our wellbeing and increased prosperity is the US dollar, the euro or the renminbi yuan? To understand why we have local currencies, we need to go back in history, to a time when banking services were not widely available. Up until the 1960s in most Caribbean countries, all retail transactions and many wholesale transactions were settled with notes and coins. The means of payment were always scarce in those days, because our countries are so distant from the European capitals that issued the world’s major currencies. Reports from the colonies of European nations in the Caribbean and elsewhere in the 17th, 18th and 19th centuries are replete with complaints about the shortage of the means of payment, and the stifling effects on commerce and industry. In the English Caribbean colonies, people were forced to resort to expedient measures: Spanish pesos were more readily available than English coins, but a single peso would frequently exceed the value of a prospective transaction. The custom arose of dividing the peso into eight equal segments. The “piece of eight” was in fact a Spanish peso that was valued at eight “bits”.

The currency scarcity in the Caribbean was somewhat alleviated with the arrival of banking services in the 19th century. Payments could now be made by means of a written instruction to a bank. The cheque instructs the bank to make a deduction from the buyer’s monies that had previously been deposited with them, when the seller presents that instruction. It obviates the need for currency, for those with bank accounts.

But banks were few and far between, and most people did not have a bank account. They needed a secure payment instrument that could be used by anyone who did not have a bank deposit. In

other words, a unit of currency. Currency notes were much cheaper to manufacture and transport than were coins, and, like cheques, they could be made in high denominations. A gold coin of equivalent value would be very much more expensive to store, transport and keep secure.

In the first half of the 20th century it became commonplace in countries of the British Empire to issue local currency notes and coins, with values fixed to Sterling (for the most part; the Bahamas and Bermuda were exceptions). These currencies were issued by special Government departments, termed Currency Boards. The Currency Board held an amount of Sterling with the Bank of England or with the British Crown Agents, and issued an equivalent amount of local currency. In this way the amount of the local currency issue could be more easily tailored to local needs. In the Caribbean there were Currency Boards covering the Lesser Antilles and British Guiana; Jamaica and the Caymans; the Bahamas; British Honduras (Belize) and Bermuda.

Up until 1971, all currency values were fixed, and those values, including Sterling, were ultimately determined by the US dollar value of an ounce of gold. In such a system, local currencies played a vital role in providing a secure means of payment, one that had a known, dependable and unvarying value. Currency notes circulated widely in the population in the process of buying and selling, available to anyone who needed to make a payment of any kind. Apart from businesses and wealthy households, everyone used currency make payments.

In contrast, in today's world, few transactions of any consequence are settled with the use of notes and coins, and the issue of currency is typically a small proportion of the total money supply and transactions value in any modern economy. Most payments, however initiated, are settled electronically, and end with a computer record in the seller's bank that shows a deposit increase, and a computer record in the purchaser's bank that shows a deposit loss or credit increase, of equivalent value. That is so whether the means of payment is an instruction sent from a computer, a credit or debit card, a cheque or any other means of payment, other than an exchange of notes and coins.

Up until 1971 the values of all Caribbean currencies were known and unchanging. The international economy of the time operated on what was referred to as a *de facto* US dollar standard. The US dollar, whose value was set by the Federal Reserve at 35 dollars per troy ounce of gold, was already the most widely used international currency. All other currencies, including Sterling, were priced in terms of US dollars. The British West Indian dollar, which was the currency in use in the Lesser Antilles and British Guyana until 1965, was issued by a Currency Board with headquarters in Port-of-Spain, at an unvarying value of BWI\$4.80 to Sterling. Its value in US dollars was derived from the Sterling-US rate, which was changed only once in the post-1945 period, in 1967.

This system worked well, so long as currencies were anchored on a single universally used reference, the US dollar price of an ounce of gold. In this sense, the currency system resembled systems of weights and measures, such as kilometres or kilograms. However, the whole system of currency values fell apart when the US effectively moved off the Gold Standard at the time of the Smithsonian Agreement in December 1971. (The Agreement, between the G-10 nations, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the UK and the US, was for a change in the US dollar value of gold to 38 dollars, and there were several subsequent

devaluations. In October 1976 reference to gold was removed from the definition of the dollar, long after it had ceased to be relevant.) For a time Caribbean currencies remained linked to Sterling, but most external transactions were in US dollars, particularly on the import side. This caused inflation locally every time Sterling depreciated against the US, and one by one the Caribbean currencies switched to a US dollar peg.

... but domestic currencies are a nuisance in today's world

The world of commerce and finance today bears no resemblance to the world for which Caribbean currencies were devised. Currency notes and coin, mostly of uncertain value in terms of purchasing power of the everyday goods and services we need to source abroad, are little used domestically. Mostly we use electronic transfers, cheques and credit cards. Since these are all computer records, it is immaterial how they are denominated, so long as both ends of every transaction match. There is no reason to link the denomination of the electronic transactions to the value of notes and coins. We continue to do electronic payments in local currency only because we have not thought deeply about the problem. We refer to notes, coins and bank deposits as "money", and we use that term as a synonym for "currency". The proverbial man from Mars would find that perplexing: currency and bank deposits both may be used for making payments, but they are clearly two very different ways of making payments. Bank deposits may be precisely defined electronically; their value may be derived precisely from instructions about how the electronic record is to be read. That record may be rendered either as an amount of Trinidad-Tobago dollars, or an amount of US dollars or a multiple of TT dollars. That multiple is currently about 6.8, I believe. I can see no reason why that multiple should ever change, or why we should bother to define the electronic record in anything other than US dollars.

Notes and coins are another matter altogether. Jamaican currency can only be used to settle transactions in Jamaica. If the payee is in the US, the holder of Jamaican dollars must seek a supplier of US dollars who is willing to sell, and pay whatever is the going price. With the demise of the US dollar standard, there is no certainty about how that price may fluctuate. Experience with currencies of small countries worldwide shows that they all lose value over the long term, in some cases drastically so. Because the notes and coins lose value, there is no reason deposits should decline in value equivalently. Deposits with banks are matched with an equal or greater value of credit on the asset side of the balance sheet. They may therefore be denominated in US dollars rather than local currency, so long as an equivalent amount of credit is simultaneously denominated in US dollars. Nothing changes.

The problems of having your own currency

In the first place, there is little or nothing useful that you can do with an Eastern Caribbean dollar, in any community that does not have access to US dollars. You cannot find anything to buy, because there will be no imported goods of any kind, and also no local production, because there is nothing that is produced in the Eastern Caribbean that does not use some essential imported material or equipment. Equally, you will not be able to produce food for yourself, or make clothing or shelter, because there is no-one from whom you can purchase equipment and materials. Our economies prosper to the extent that there is an ample inflow of foreign currencies, which may be spent on the imports we consume and use in domestic production.

Companies and individuals who earn foreign currency are privileged, compared with those who are paid in local currency, in much the same way as Haitians who speak English are at an advantage, compared with those who only speak creole (*kreyol ayisyen*). Having your own currency gives a good feeling, but it actually makes second-class citizens of the less well-to-do.

Secondly, your local currency is not a good choice for placing your savings, because its value may be depreciated, relative to the US dollar, at the time when those savings are needed. Guyanese and Jamaicans who retired in the 1980s and 1990s found that the value of their pensions had shrunk to the point where they were entirely dependent on the charity of their offspring for their livelihood. Even in Belize, the ECCU and Barbados, where there has been no devaluation, people prefer to save in US dollars if they can, just in case. Local currency deposits and securities are an inferior option, which will be chosen only if you have no US dollars.

Thirdly, local currencies are in danger of devaluation whenever government's operating expenses exceed tax revenues for several years running. In these circumstances government accumulates unproductive debt, debt that does not contribute to the provision of communications, roads, ports, or lasting upgrades of health, educational and social services. Because Government's borrowing does not contribute to additional knowledge and capacity to earn foreign exchange, it does not generate a stream of revenues to service the loans contracted by Government. The result: in addition to meeting current import needs, some portion of the available supply of future foreign exchange must be set aside to service the new Government debt. That means less foreign exchange for current imports, and pressure for devaluation of the currency.

In practice, having a local currency has facilitated wasteful government spending and reduced the incentives for the reorganisation and modernisation of the public sector, throughout the Caribbean. In the absence of a local currency, Government would be obliged to maintain credit worthiness in order to borrow in US dollars. That would be an incentive to raise public sector productivity and resist the more egregious forms of pointless job creation. With its own currency, Government can make a great show of passing legislation for central bank independence, while continuing with policies that undermine the value of the currency.

The threat of domestic currency depreciation brings challenges that inhibit the country's economic development prospects. It undermines investor confidence, because prospective investors know that devaluation will be inflationary, and will trigger increases in import costs and unease and possible unrest in the labour force. Investment projects are put on hold until the threat of devaluation recedes. The threat of devaluation also leads to capital flight, as businesses and wealthy individuals switch to US dollar balances, pay off US dollar trade credits and borrow in local currency wherever they can.

Depreciation of the domestic currency worsens the distribution of income. Wealthy households have access to US dollars through a variety of channels. They may own or manage international trading companies or financial institutions, they may have foreign clients, relatives or business associates, and they may have foreign sources of income. Their foreign income and income-earning assets protect them from the impact of currency depreciation. Public servants, persons employed in domestic activity and lower income earners are paid in local currency, and their avenues for converting to US dollars are limited. They cannot escape the inflation that comes

with a devaluation of the local currency. Devaluation widens the gap between the haves, who can protect their income by switching to US dollars, and the have-nots, who are stuck with local currency which has lost some of its purchasing power.

There are no benefits to having your own currency

We are often told, by the IMF, journalists and commentators, that our countries may improve their competitiveness by devaluing the local currency. Anyone who has taken a basic course in economics should know that that is erroneous. Small producers operate in competitive markets in which their contribution to the market is too small to make a difference to the ruling price in the market. At the ruling market price they may sell everything they produce, so why would they want to offer a lower price? In the case of tourism, minerals and other Caribbean products, prices are denominated in US dollars. What determines the return to the Caribbean producer is the quality of the product or service, a factor which is unaffected by the devaluation of the local currency. The argument that devaluation increases competitiveness is totally without merit, no matter how often it is repeated.

What is true is that devaluation reduces the wages of local workers, measured in US dollars. Hotels, restaurants and export activities become more profitable, at the expense of their workers. That does not seem to be a desirable outcome.

The IMF and mainstream media also regularly state that countries with their own currencies may limit the extent of domestic inflation, by raising domestic interest rates when prices rise beyond a target level. That is also clearly erroneous. The principal factors affecting domestic inflation are the prices of imports and the depreciation of the currency; domestic interest rates have no discernible effects on prices.

There are positive spinoffs of using the US dollar exclusively for local transactions

Government's fiscal indiscipline cannot erode the value of people's savings if there is no possibility of creating domestic credit to fund Government's deficit. Government borrowing from the central bank would be limited to the amount of deposits placed with central bank by commercial banks, and would be used to smooth out government's cash flow. Government finances would become subject to the discipline of the market. Government would be obliged to maintain a good international credit rating, and it would need to present careful and complete public documentation for projects for which it seeks funding. Public accounting for borrowings, including guarantees of the borrowing of state corporations, would be demanded by potential creditors, because they would be aware of the limits to Government's ability to borrow from the central bank.

Fears of devaluation, shortages of foreign currency, exchange controls and the bureaucracy that surrounds them would be a thing of the past. The boost to investor confidence, the positive impact on the commercial environment and the improvement in the ease of doing business, would be notable.

Exclusive use of US dollars would alleviate a major headache for the Caribbean and small countries around the world, namely the wholesale loss of correspondent relationships with international banks which deal in US dollars. The loss of correspondent banking relationships

has inhibited remittances, turned away potential investment in international financial centres, and inconvenienced individuals who spend extended periods in the region and need to do business in local currency.

How to retire the local currency

The local currencies could be entirely redeemed by central banks by purchasing and importing US currency notes and coin, using their existing foreign reserve balances. Central banks and monetary authorities in the Caribbean all have foreign reserves sufficient to purchase US notes and coins to replace the full issue of local currency at prevailing exchange rates (See Table 1).

Table 1. Currency Issue and Foreign Reserves, Local Currency

Country	Currency Issue	Foreign Reserves	Date
Aruba, Fl.m	336	1636	Dec 2018
Bahamas, Bh\$m	304	1182	Dec 2018
Barbados, Bd\$m	732	991	Dec 2018
Belize, Bz\$m	376	575	Jan 2019
Bermuda, Br\$	124	154	Dec 2017
Curacao, St M. Gm	458	3140	Dec 2018
DR, Pesos, b	123	367	Dec 2018
Guyana G\$b	106	112	Dec 2018
Haiti Gourdes, b	44	165	June 2018
Jamaica, J\$b	94	400	Dec 2017
Suriname			
T' dad-Tobago, TT\$b	8	53	Dec 2018

Sources: Central bank websites

All deposits and other liabilities of the banking system are held in digital records, and are matched by an equal amount of credit and other assets, also held in digital form. All that would be required for these balances is to covert both sides of the balance sheet from local currency to the US dollar equivalent at the prevailing exchange rate.

Objections that may be offered to full dollarisation

It is sometimes argued that in the absence of exchange controls the local economies would be denuded of investment or, conversely, overrun by foreign investment. In fact, investment is attracted to the Caribbean because of competitive advantages and the prospect of profitability; the existence of exchange controls slows down potential investment inflows, and their removal would eliminate this obstacle. Some also argue that there would be danger of environmentally damaging or other inappropriate investment, or massive investments that may transform the landscape in socially undesirable ways. These dangers should be managed by planning, environmental and other legislation and regulation.

There is an objection raised that the US Federal Reserve would not approve of the domestic use of US dollars. The issue of Federal Reserve approval does not arise because the Caribbean central banks would have no authority to *issue* US currency. Caribbean central banks would

continue to buy and sell US dollars from the Fed as they do now, as the local demand for currency varies. The Fed would continue to manage such US dollar assets as central banks might deposit with them from time to time. No change in the current arrangements is necessary.

The IMF frowns on the use of US dollars as the national currency. This would be a problem for countries such as Barbados which has a current IMF programme; the Barbadian Government would need to convince the Fund's Board of Directors of the merits of full dollarisation.

A problem would arise if the central bank lacks sufficient foreign currency to cover the outstanding currency with the banks and the public. In this case commercial banks might be willing to use their own foreign assets to retire their holdings of local currency. However, at the moment no Caribbean central bank is in this situation.

Dollarisation and national sovereignty

Retiring local currency is seen by uniformed observers as a surrender of economic sovereignty. In fact, exactly the opposite is true: exclusive use of the US dollar enhances the range of choice open to the country and its residents, in all international commerce, because such transactions are conducted in US dollars or in currencies that are convertible to US dollars. In contrast, with Barbados dollars you cannot buy or sell anything in nearby St Lucia, much less in the rest of the world. In a world where payments and settlement are digitized, with no need for notes and coin, there is no limit on the commercial and financial sovereignty of holders of the US dollar.

It follows that the use of an independent local currency limits a country's sovereignty, because it limits the ability to engage in international commerce. The GDP of Barbados in 2018 was about US\$5 billion, but the country had access to less than US\$3 billion of international goods and services, because that was the total availability of US dollars and other foreign exchange from exports, tourism and other services, and foreign financial inflows. Once the economy is fully converted to US dollars and the local currency fully retired, the entire US\$5 billion may be used to obtain the best value for money, in transactions anywhere in the world.

It is evident from Panamanian experience in the wake of the release of the "Panama Papers" that full dollarization does not safeguard a country against the risks on international commerce, including the reputational risks. Arguably, however, full dollarization mitigates the effects of adverse circumstances, and strengthens to country's resilience in the face of such events. Had Panama boasted its own currency, the release of the Panama Papers would undoubtedly have led to capital flight, major currency depreciation and a big jump in domestic inflation, all with long-term damage to economic growth prospects and economic stability. In the event, the economic damage was limited to the international financial services sector and services such as real estate which depended on that sector.

Experiences with full dollarisation

The Latin American and Caribbean region offers three examples of full dollarization: Panama, which has always used US dollars as local currency; Ecuador, which abandoned the local currency in 2000; and El Salvador, which replaced local currency gradually, starting in 2002. Their growth and inflation performance since 1990, relative to the regional average, is shown in Figures 1 and 2.

In Figure 1 we see that Panama's growth has significantly outrun that of Latin America and the Caribbean since 1990. At the end of 2016, Panama's annual GDP was over four times as large as it was in 1990, compared with the regional average, which was less than double. Panama's GDP rose faster than the regional average consistently over the past three decades. Ecuador and El Salvador also outperformed the regional average, but less spectacularly. In the case of Ecuador, in the earlier years when it still retained its own currency, growth was no better than average, but the growth rate accelerated past the regional average after full dollarization. In 2016 Ecuador's GDP was 222 percent of the 1990 figure, compared with the regional average of 173 percent. The relative growth of Salvadorean GDP shows no noticeable change during the period of full dollarization. The economy fell into recession five years later, but by 2016 it was slightly ahead of the regional average, at 190 percent of 1990 GDP.

Panama's inflation performance bettered the regional average by a wide margin (see Figure 2a). Relative to international prices, Panama's domestic prices in 2016 were only 84 percent of what they were in 1990. In the past decade domestic prices in Panama have risen more slowly than international prices, whereas for the region the slowdown of domestic prices is noticeable only in the last two years. In Ecuador, domestic prices rose much faster than international prices prior to full dollarisation (Figure 2b). Dollarisation in 2000 was accompanied by a sharp correction, which brought domestic prices in line with the regional average, but the effect was short lived, and relative prices more than doubled in the next three years. Since then domestic price increases have been in line with the regional average, though there have been wide fluctuations over the years. In El Salvador domestic price increases levelled off after full dollarization, ending the period very close to the regional average (Figure 2c).

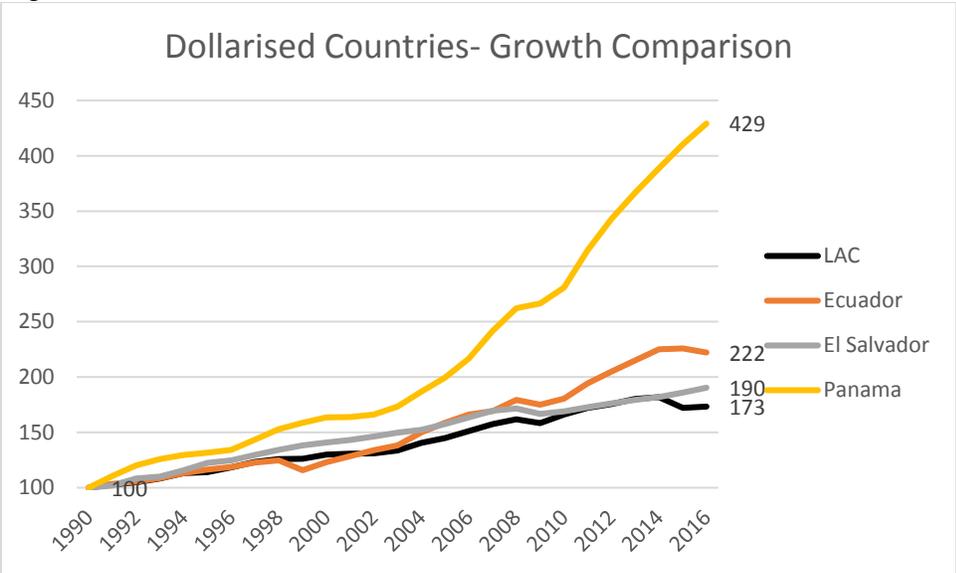
These illustrations are not intended to demonstrate the benefits of full dollarisation. That would require an in-depth analysis of the circumstances of each country, taking account of economic structures and policies, and of international economic activity, among the many relevant issues which are beyond the scope of this essay. The growth and inflation data are intended only to allay fears about the possible adverse consequences of full dollarisation.

Are the currencies of all small economies doomed to extinction?

The currencies which will have the longest life are those whose governments have consistently observed the Golden Rule: the government's expenditure on current operations and debt service should at all times be less than the revenues from taxation. In this way there is always a small surplus available to contribute to the replacement and modernization of equipment, property and infrastructure, and the entire amount of government borrowing is devoted to investment projects. Governments which observe the Golden Rule borrow from their central banks only to even out their cash flow, and amounts borrowed in advance of periodic tax returns are fully paid off with the receipt of the anticipated taxes. Central bank credit to government does not increase over time, and there is no pressure on foreign reserves, which can be maintained at a level sufficient to protect the exchange rate against a loss of value over the long term. For such governments the fact that their currency retains its value against the US dollar and other international trading currencies, and the adequacy of their foreign reserves, are easily identifiable markers of good financial management by government. A country with this reputation earns a high credit rating in international financial markets. The only remaining value of having your own currency,

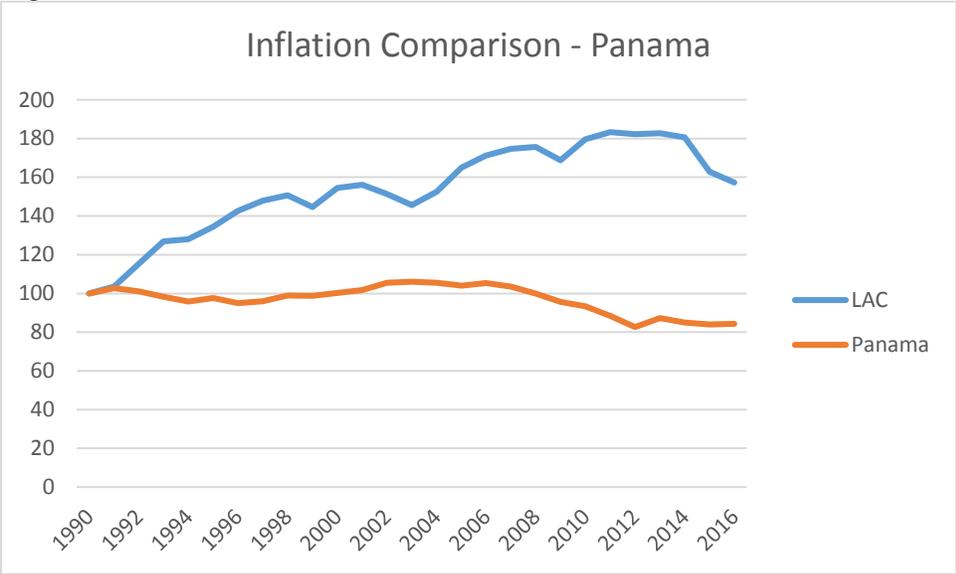
therefore, is as a signal that government is committed to sound financial management. When that is no longer the case, the currency will depreciate, and the process of replacing it with US dollars will accelerate, beginning with the wealthiest in society. It then makes sense to retire the domestic currency in a quick and orderly process, rather than engage in a long and fruitless struggle to maintain its value.

Figure 1.



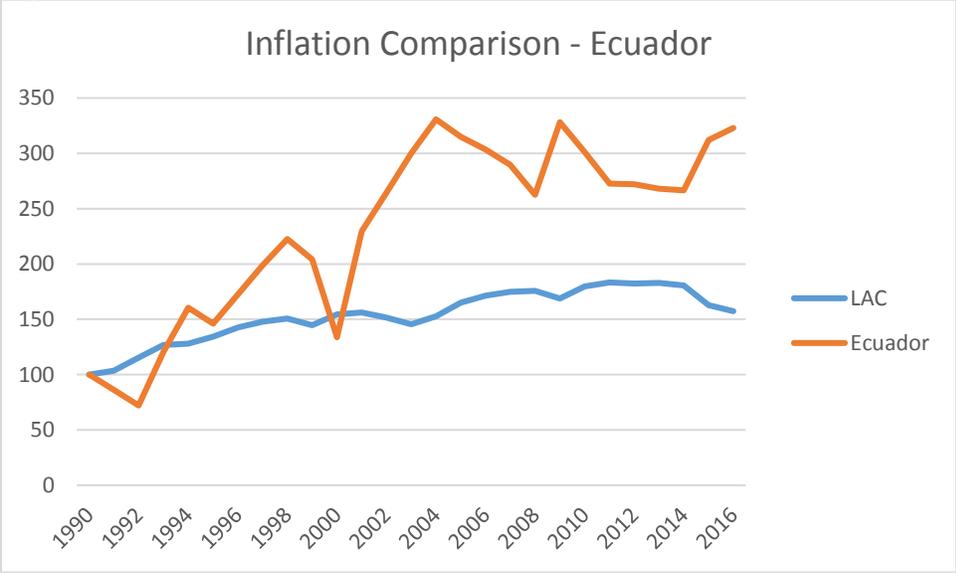
Source: ECLAC Annual Statistical Report 2017

Figure 2a.



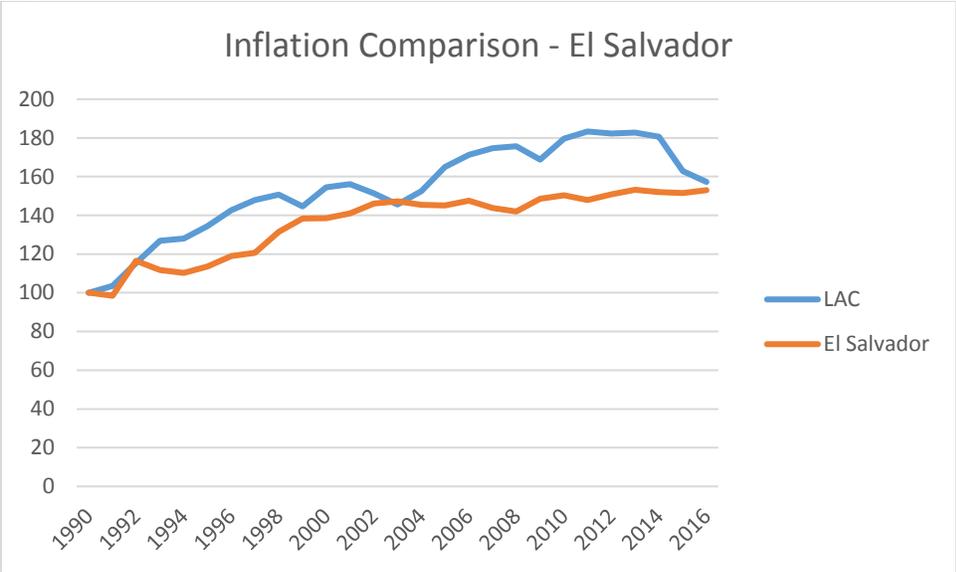
Source: ECLAC Annual Statistical Report 2017

Figure 2b.



Source: ECLAC Annual Statistical Report 2017

Figure 2c.



Source: ECLAC Annual Statistical Report 2017