

EXCHANGE CONTROL:  
YESTERDAY, TODAY, AND TOMORROW

Alvin Rabushka  
Senior Fellow  
Hoover Institution  
Stanford University  
(Economic Adviser, Securities Market Task Force)

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Ladies and Gentlemen,

I am delighted to speak to this distinguished audience on what must be everyone's favorite subject—money. Like everyone else, I have a great admiration and respect for money. I have been an avid collector of bank notes for many years, and have a wonderful collection of Bahamian notes, which has been among my better investments. Old Bahamian notes have appreciated more rapidly than real estate and equities during the past decade. Some old uncirculated notes with portraits of King George and Queen Elizabeth now command over \$1,000 each. This fact, along with the lovely colors and scenes that characterize Bahamian dollars, are the good news.

The bad news is that one cannot spend Bahamian dollars anywhere in the world outside these lovely islands, as I learned to my dismay on an American Airlines flight two years ago. Your Bahamian dollars of today are not as good as sterling or U.S. dollars, as was true for the older shillings and pence or the early government or Bahamas Monetary Authority dollar note issues. The Central Bank of The Bahamas will not let you convert as much as you want of Bahamian money into hard currency. Will the Central Bank ever relinquish this control? This is the topic I wish to explore today.

### **The Historical Legacy**

A bit of history is helpful in trying to answer this question. First, the public finances. All British colonies, including The Bahamas, were subject to the colonial regulations, which stipulated that colonies manage their public finances strictly on a balanced-budget basis. When The Bahamas proclaimed its independence, the country was virtually free from public debt.

A second colonial institution was the currency board monetary system, which has enjoyed a modern rebirth in such countries as Argentina, Estonia, Lithuania, Bosnia, and Bulgaria, and which remains intact in Hong Kong and the Cayman Islands. A currency board is a monetary system that maintains a fixed

exchange rate and full convertibility on both the current and capital account between domestic notes and coins and some reserve currency. A currency board achieves its purpose by holding 100 percent external reserves against the domestic note issue.

A currency board does not have discretionary control over the domestic money supply. Under the currency board monetary system, surpluses or deficits in the balance of payments translate into increases or decreases in the domestic money supply. This arrangement is similar to the classical gold standard, balance-of-payments monetary system.

It is important to understand what a currency board cannot do. It cannot finance spending by the domestic government or domestic state enterprises because it is not allowed to lend to them. A typical currency board is not a lender of last resort. It does not lend to commercial banks or to other enterprises to help them avoid bankruptcy.

The Bahamas shifted from a currency board to a central banking monetary system in 1968 with the creation of the Bahamas Monetary Authority, which was followed by the establishment of the Central Bank of the Bahamas in 1974. In contrast with the former currency board, the Central Bank was empowered to buy government debt and also serve as lender of last resort to the commercial banks, which effectively enables them to buy government debt without risk.

Where does exchange control figure in all this? During the currency board era, no control was placed on foreign exchange transactions inside the sterling bloc, until the United Kingdom disbanded the bloc when it floated sterling in July 1972. After that date, sterling also became a foreign currency in The Bahamas. At that moment, the Bahamas Monetary Authority, and then its successor, the Central Bank, assumed responsibility for exchange control between the Bahamian dollar and foreign currencies.

The newly independent Bahamas could have reestablished a currency board monetary system, using U.S. dollars as its reserve currency as, for example, is

found in the Cayman Islands or Hong Kong. It did not. Instead, the government established a Central Bank. This act, which was common to almost all newly-independent nations, set The Bahamas in a new fiscal and monetary direction.

The advent of internal self rule and the establishment of the Central Bank eliminated the colonial balanced-budget requirement and permitted the Bahamian government to sell public debt to the Central Bank, the commercial banks, pension funds, insurance funds, and, most important, the National Insurance Board after it was established.

### **The Current Situation**

Let me turn to the present day. The future development of The Bahamas is threatened by the accumulation of a massive public debt that continues to rise year-in and year-out. The existence and growth of this debt is a, if not the, principle reason for the need to maintain a regime of exchange control.

Since 1973, the public finances have undergone steady deterioration. The relative size of the public sector has increased from less than 15 percent of the gross domestic product (GDP) to just over 20 percent of GDP. In addition, the public debt of the country has steadily increased. The pace and growth of public debt accelerated during the 1980s and 1990s, pushing up the total direct national debt to \$1.24 billion by the end of 1996. When the contingent liabilities for the public corporations of \$307 million are added in, the total national debt amounted to \$1.54 billion at the end of last year, some 40 percent of GDP.

### **Exchange Control**

Now we come to the politically charged topic of exchange control, a subject of ongoing controversy in The Bahamas, and I will add to that controversy today—but with a surprising twist. First, some facts. The Bahamas is an Article VIII member of the International Monetary Fund, which requires that no restrictions be placed on current account transactions, unless the balance of payments is in

jeopardy. Exchange control, however, applies to capital account transactions (e.g., loans, equity investments, and inward and outward direct foreign investment).

The Bahamas issues its own independent currency, the Bahamian dollar, which is set at parity with the U.S. dollar. The Central Bank maintains parity by a combination of external reserves in the form of U.S. dollars and a system of exchange control. A certain level of foreign reserves is required to insure the inflow of imports, which must be paid for in hard currency.

But a crucial point must be kept in mind. The issue of local currency does not mask the reality that the economy of the islands effectively rests on U.S. dollar earnings from tourism and financial services. To put this in technical language, high-powered base money in The Bahamas is not Bahamian notes and coins in circulation, but is U.S. dollar reserves of the Central Bank. In practical terms, a decline in U.S. dollar reserves prompts the Central Bank to advise the commercial banks to tighten credit, thereby slowing imports

The Bahamas does not have a typical central bank because discretion in monetary policy is restricted by the Bank's determination to maintain a fixed rate of exchange at parity with the U.S. dollar. The Central Bank must maintain a sufficient level of foreign reserves to meet foreign dollar liabilities on current account transactions. So long as reserves are adequate, this objective can be met in the conduct of normal business. However, any diminution in foreign reserves reduces the ability of those holding Bahamian dollars to acquire foreign currency to pay overseas bills or move capital abroad.

A description of the money supply and the composition of domestic credit is required to fully understand why the Central Bank maintains exchange control on capital account transactions, *and why it is likely to do so for the foreseeable future, and why the situation may even get worse before it gets better.*

Please bear with me as I work my way through some of the statistics that appear in the February 1997 issue of the *Quarterly Statistical Digest* issued by the Central Bank of the Bahamas.

Table 1.1 (page 1) shows that at the end of 1984, external reserves stood at \$162.5 million. Twelve years later, at the end of 1996, the reserves amounted to \$163 million, almost the identical figure. These reserves constitute the real high-powered base money in The Bahamas, since everything that is imported must be paid for in the reserve currency, and all outward capital payments must be made in the reserve currency.

The last column in Table 1.1 reveals that the total assets of the Central Bank increased from \$219 million to \$335 million during 1984-1996. These assets consist of Treasury bills, which rose from \$10 million to almost \$80 million, long-term securities that increased from \$5 million to \$21 million (although off their high of \$42 million of 1990, a positive trend), and short-term advances to the government that almost doubled from \$28 million to \$52 million. This last figure is restricted by law. Otherwise, it would undoubtedly go higher.

Virtually the entire increase in assets held by the Central Bank consists of various forms of government debt. These are not "hard" assets. In economic terms, the growth in assets constitutes liabilities of the government, or, more properly, the taxpayer. The actual "real" assets of the Central Bank, its external reserves, are unchanged. This amounts to a huge dilution of real assets as a share of total assets. External reserves constituted 74 percent of total Central Bank assets at the end of 1984. At the end of 1996, that ratio had declined to 49 percent. Don't blame the governor of the Central Bank as it is impossible for him to refuse to buy government debt.

To repeat, and repeat as many times as is necessary for the point to sink in, high-powered base money (a pitifully small level of external reserves) is the ultimate support for the entire domestic credit structure, plus that portion of the public debt not counted in the  $M_3$  measure of money supply. The  $M_3$  broad measure of money supply increased from \$878 million in 1984 to about \$2.3 billion in 1996, an increase of 157 percent (Table 2.3). This means that a much higher money supply is supported by the same nominal level of external reserves, but which is smaller in relative terms.

Domestic credit consists of loans to the government, commercial bank credit, and credit granted by other local financial institutions. In December 1996, net domestic credit to the government stood at \$400 million. Of this the Central Bank provided \$153 million; commercial banks and other financial institutions, \$247 million. Domestic credit to public corporations amounted to about \$91 million. Domestic credit to the private sector came to just under \$2 billion.

Tables 8.1 and 8.2 in the Central Bank's *Quarterly Statistical Digest* disclose the central government's national debt. As previously noted, large deficits in the 1990s ran up the total direct charge from \$870 million in 1991 to \$1.24 billion in 1996, and another \$308 million in contingent liabilities. All but \$77 million is denominated in local currency. The government's share, including public corporations, of domestic credit is about 20 percent.

The real monetary base of The Bahamas, \$163 million of foreign reserves at the end of 1966, supported a domestic money supply of about B\$2.3 billion, along with a direct national debt of \$1.24 billion, of which only \$491 million appears in the December 1996 money supply statistics. The other \$750 million of government debt also represents someone or some institution's assets. This puts a bottom estimate of Bahamian-denominated financial assets at about \$3 billion. The value of Bahamian equities adds another \$400 million to the pool of local currency assets. The ratio of Bahamian financial assets to official U.S. dollar reserves is about 21 to 1. For every U.S. dollar in the Central Bank available to finance imports or capital outflows, there is \$21 worth of Bahamian financial assets, or claims, excluding real estate.

In the absence of exchange control, any rush to convert domestic financial assets into U.S. dollars would quickly exhaust foreign reserves. Private pension funds in The Bahamas, which hold Bahamian dollar assets exceeding \$400 million, could exhaust all foreign reserves if they shifted roughly half of their portfolios from bank deposits and local equities to foreign equities and bonds. Insurance companies could drain all foreign reserves if permitted to diversify abroad. The National Insurance Board could wipe out the reserves several times over. As the NIB's assets rise in proportion to the Central Bank's foreign reserves, they become increasingly locked in or locked up.



To repeat, the entire structure of Bahamian dollar financial instruments, and the ultimate value of real domestic assets, rests on a precariously small, and getting relatively smaller, base of U.S. dollar reserves, which is essential to pay import bills. The reserves are way too small to pay import bills and accommodate even a modest conversion of Bahamian assets into foreign currency.

### **The Dreaded "D" Word: Devaluation**

If the value of the domestic money supply, public debt, and other Bahamian financial assets continues to grow without a corresponding rise in foreign reserves, even current account transactions are likely to become subject to some form of direct or indirect exchange control. This development would put The Bahamas' status as an Article VIII member of the IMF at risk and send a dreadful signal to the global business community. Let me outline the potential risk.

Sustained money supply growth and an expanding pool of Bahamian financial assets mean increasing demand for housing, goods, and services, which in the open economy of The Bahamas translates into rising imports and pressure on the meager reserves. All Bahamian imports must be paid for in foreign currency.

The trend line of imports will remain upward because the population is increasing, money demand is rising, and tourism looks set to remain healthy. The inevitable consequence of this trend must be tighter control over access to foreign exchange and imports. This, in turn, means reduced consumption and declining living standards for an ever-increasing population. So long as the population remains acquiescent in the face of falling living standards, the Central Bank can maintain parity between the Bahamian and U.S. dollars.

At some point, increasingly stringent foreign exchange control cannot be maintained in the face of declining imports, consumption, and living standards. Jamaica, Trinidad & Tobago, and dozens of countries around the world have been forced to devalue their currencies in response to an external balance-of-payments problem brought about by an imbalance between a growing domestic money supply coupled with a rising public debt and dwindling foreign reserves. Jamaica, Trinidad & Tobago, and countries that have been forced to devalue are not shining

examples of opportunity and prosperity.

At the end of 1996, \$163 million of foreign reserves supported more than \$3 billion in Bahamian financial claims. Unless foreign reserves rise to, and remain at, a higher level in the near future, the financial structure of the Bahamian economy, which resembles an inverted pyramid, will continue to get heavier and larger at the top. At some point, the whole structure will topple. Either devaluation or new restrictions on current account transactions, which means import control, must follow.

Currency devaluation confiscates domestic savings by devaluing external purchasing power, even as it accomplishes the goal of relieving pressure on the country's financial system by wiping out in real terms nominal debt claims against the government and the banks. In effect, the government makes itself whole by nationalizing savings and slashing each Bahamian's purchasing power from savings and earnings. So what if the banks' assets, its loans, are similarly savaged.

In a worse-case scenario, there is a risk of a run on the banks and the entire domestic credit structure if Bahamians *en masse* rushed to convert Bahamian assets into U.S. dollar assets. The price of Bahamian assets would sharply contract. A run on the banks would force the banks to call in their loans, in so doing throwing the economy into sharp recession or even a depression. This process occurred in the U.S. in the 1930s. It has also taken place throughout the newly-independent Central and Eastern European countries after 1989, when citizens of these countries chose to put their savings under the mattresses in the form of U.S. bank notes. In most cases, GDP fell by half and currencies were sharply devalued.

A severe consequence of the growing debt and money supply is that the National Insurance Board will be unable to meet its pension obligations, unless tax rates are increased or benefits are reduced. Any devaluation that might occur would destroy the real value of the NIB's assets, and with it the real value of pension payments.

The \$64,000 question is when a financial crisis might erupt and what would be the impact? Its impossible to put a date on any possible crisis, as the problem of

rising debt and money supply on a base of fixed reserves is a gradual, politically invisible, process that politicians do not believe requires immediate action. If Bahamians are prepared to stoically endure years of stagnation, rising unemployment, deteriorating social conditions, and falling living standards, an explosive financial crisis can be postponed almost indefinitely.

It's fair to ask if parity between the Bahamian and U.S. dollars is sacrosanct? It's convenient for tourists and Bahamians, but it is neither a necessary or sufficient condition of economic growth. There is no intrinsic reason why the government and Central Bank cannot scrap the current monetary arrangements in favor of a floating Bahamian dollar, as now exists in Jamaica and Trinidad & Tobago, to name two prominent Caribbean examples. However, during the transition, there will be winners and losers. The losers will be unsophisticated working Bahamians, who will hold the government accountable. Nor does international evidence demonstrate that devaluation can produce sustained growth and eliminate endemic fiscal and monetary imbalances.

If the government is ever forced to turn to the IMF for financial or balance-of-payments assistance, the IMF might demand that the Bahamian government increase taxes, impose new taxes (perhaps even the dreaded income tax), slash government spending, and take other necessary steps to achieve external equilibrium. (The case of Russia is instructive. Russia has to meet strict IMF dictates to receive its monthly Extended Fund Facility loan. The IMF leans hard on Russia to increase its tax efforts, withholding monthly loan payments whenever revenues fall below agreed-upon levels.)

If parity between the U.S. and Bahamian dollars is regarded as sacrosanct, then Bahamians can look forward to a future of rationing and rampant smuggling. Neither devaluation or import controls are bright prospects. But one or the other is inevitable in the not-too-distant future if the country continues on its current path.

This talk, from a concerned outsider, is a wake-up call. There is a lot more to say on this subject, but you have been patient to listen to me after lunch and you need to get back to work. Thank you for your kind attention.