

FOREIGN EXCHANGE ACCOUNTING AND MANAGEMENT

A PROPOSAL

by

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It is the horror of the Jamaican and Guyanese experience over the last few years which has provided a practical impetus for proposing measures to save Trinidad and Tobago from a similar fate.

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The limitations of this paper, as usual, remain the responsibility of the author.

Foreign Exchange Accounting and Management in Small Economies:

A Proposal

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Introduction

The necessity of foreign exchange management has become apparent in the context of persistent balance of payment disequilibria by, and related growing foreign debt commitment of, a growing number of Third World countries. Foreign exchange management may be defined as that mix of national policy measures which seek to directly (and sometimes indirectly) influence the net availability of foreign exchange overtime with the objective of achieving balance of payments equilibrium.

Small economies such as those of the Caribbean, however defined¹ face even more severe adjustment problems than other Third World economies in realizing external balance. The very fact of smallness reduces the policy options for adjustment. Demas was one of the first Caribbean economists to draw our attention to the constraint imposed by size (Demas, 1965). Best and Thomas have correctly pointed to the historical and structurally-imposed constraints to Caribbean development, perhaps downplayed by Demas (Best 1971, Thomas 1974). Mc Intyre made a useful intervention in this debate on small size by distinguishing between functional constraints deriving from the manner of incorporation into the world economy, and structural constraints resulting from small size (Mc Intyre, 1971). A recent comparative study of four small economies in transition to socialism by Morawetz suggests that smallness remains a binding constraint: "Although increasingly

the degree of natural economic independence is a central aim for most SDC's (Socialist Developing countries) there is a fundamental difference between large and small economies in this regard. A large country that is relatively rich in resources such as China may have the option of following a fairly autarkic development policy; a small country probably does not. As a small SDC develops, it is likely to need increasing amounts of machinery, raw materials and intermediate inputs.Clearly then, if a small SDC is to avoid running into a foreign exchange bottleneck, it has to ensure that its exports increase steadily over time.following a socialist strategy does not absolve a small country from looking after its export growth anymore than following a capitalist path does." (Morawetz, 1980 pp).

Smallness therefore implies openness. Closure or autarky is virtually impossible for two main reasons. Firstly, domestic markets will be too small to permit either economies of scale or to clear the labour market. Secondly, the resource base of small economies will be too limited to allow the full range of consumer and capital goods to be supplied solely from domestic supply.

Two characteristics are likely to be common to small economies, whatever the economic path followed:

- (1) Such economies will always possess a continuous, substantial demand for foreign exchange relative to their foreign exchange earning capability;

- (2) However, such economies will experience significant fluctuations in their foreign exchange earnings over the short, medium and long-run.

Therefore, one major dimension of economic planning - derivative of the goal of creating a structurally transformed economy capable of self-sustaining growth under conditions of full employment - should be to realize the twin objectives of:

- (a) Maximising foreign exchange earnings; and
- (b) Minimising foreign exchange uses.

These twin objectives are not as contradictory as they may seem at first. A foreign exchange use which promises to yield a foreign exchange flow in the future is quite compatible with the realization of the dual objectives.

To operationalize the max-min objectives two measures are necessary:

- (1) Information on projected foreign exchange flows; and
- (2) Policy measures then can be implemented in relation to the projected net foreign exchange balance.

Part A: Foreign Exchange Accounting

The required information to realise the first element above, can be obtained through foreign exchange accounting. This is simply

Flow of Funds Accounting for sources and uses of foreign exchange. However, as in all accounting systems, categories must be informed by objectives and prior theorising.

The advantage of foreign exchange accounting is that it will provide foreign exchange data on a cash flow basis. This will be a more precise indication, therefore, of foreign exchange availability and use than Balance of Payments accounts. For example Carr provides a comparison of the balance of payments record of bauxite export earnings and actual bauxite earnings by Jamaica as recorded by the foreign exchange budget between 1977-1980². (Carr, 1981).

	<u>\$mn US</u>			
	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>
(1) Total export value as per BOP	528.5	582.3	581.7	732.7
(2) Total cash receipts as per FEB	<u>374.1</u>	<u>242.7</u>	<u>278.0</u>	<u>367.8</u>
Difference between (1) and (2)	<u>+154.4</u>	<u>+339.6</u>	<u>+303.7</u>	<u>+364.9</u>

Source: Carr 1981, Table 4

The twin objectives proposed above of maximising sources and minimising uses of foreign exchange only can be realised in the context of a theoretically derived strategy for economic transformation. Categorization, therefore, can differ, to some extent, among small economies utilizing Foreign Exchange Accounting. For the particular purpose of Trinidad and Tobago and the Caribbean the skeleton of a foreign exchange budget is proposed in Tables 1 - 5.

Tables 1 and 2 introduce the foreign exchange account in summary form. A distinction is made between Recurrent and Non-Recurrent sources and uses of foreign exchange. This is the most important analytical distinction needed although, in practice, some items may not be so clearly demarcated. A recurrent source or use as the term suggests is one which can be expected, *ceteris paribus*, to continuously provide or utilize foreign exchange, respectively, over a number of years. The criticality of the distinction lies in the fact that if an economy overburdens itself with Recurrent Uses of foreign exchange consistently greater than its earning capability, drastic domestic adjustments will become inevitable. Ironically such adjustments then may be borne by sectors other than those now entrenched recurrent users. The significance of the distinction is that it will provide a basis for projecting the net foreign exchange balance over several years. For example, given assumptions about prices and output of oil, one can project foreign exchange earnings in Trinidad and Tobago over the next 5-10 years. Forecasting is fraught with methodological problems at

the best of times - more so in the current uncertainty over oil prices. However, all rigorous forecasting recognizes its limitations and projects, normally, three alternative scenarios. It would be sensible for the foreign exchange account to utilize the pessimistic scenario as the basis for determining policy with regards to Recurrent uses of foreign exchange in particular. Recurrent uses of foreign exchange should remain within tolerable bands to avoid a balance of payment crisis. This is not to suggest that there has to be a continuous "balanced budget". However, any deficit financing must be either (a) non-recurrent or (b) projected to generate, at worst, the equivalent supply of foreign exchange to meet its future repayment and/or to lead to a fall in foreign exchange usage, (i.e. saving) substantial enough to permit repayment of any prior deficit budgeting.

One could produce a foreign exchange budget that distinguishes between Recurrent and non-Recurrent sources and uses. Given a projection for a 5-10 year period, new Recurrent commitments will then be undertaken only in so far as projected sources are available over and above existing already committed uses - Recurrent and non-Recurrent. What is recurrent for one economy, may be non-recurrent for another. The best example is that of the assembly manufacturing sector established in some Caribbean countries. Given the investment decision, such a use of foreign exchange becomes Recurrent as employment and income structures are dependent on a continuous supply of imported parts for assembly. Ally notes for example that in the Jamaican case if the original budget

use of \$600 mn (Ja) to raw materials was not maintained in 1977 some 50,000 jobs would have been lost in the manufacturing sector, (Atly 1977, p 17). In another Caribbean economy without a similar assembly sector (or sub-sector) the foreign exchange use would be non-Recurrent.

Non-Recurrent sources and uses also need to be identified and forecasted. Some items will be difficult to distinguish and may change location overtime. Obvious non-recurrent sources include grants, loans and a proportion of F.D.I. While F.D.I. always has represented a significant foreign exchange source in the Caribbean, the Jamaican experience has shown capital inflows to be unstable. This is not to raise the more general issue of the contribution of foreign investment to Third World development. Tables 1 and 2 provide some illustrative examples of international economic transactions which can be classified as Recurrent or non-Recurrent sources and uses of foreign exchange. For policy purposes it may be necessary to provide some finer categories of uses. Table 3, for example, suggests a distinction between essential and non-essential uses.³ The point of this distinction is that a use may be Recurrent but not necessarily essential - the implication being that a certain investment decision may cause the economy to commit itself to recurrent payments for what may be frivolous purposes. The best example that comes to mind is that for chicken and chips franchise holding in Trinidad and Tobago. Some foreign debt even may be so classified if it was utilized for non-productive purposes and/or was inefficiently spent. The importance of this categorisation is

that it can be used to inform exchange control permission for activities identified as non-essential but recurrent future users of foreign exchange.

Table 4 suggests a further breakdown between competitive and non-competitive uses. The significance of this categorization is that it permits the economic policy makers to identify uses - Recurrent and non-Recurrent, Essential and non-Essential where the possibilities of domestic displacement exists, for example, a use which is competitive with domestic supply - existing and potential. This provides an input into economic planning for the producing sectors.

Table 5 proposes that the net foreign exchange available, be identified in the major sectors earning foreign exchange - by Firm and Sector. This table also could be utilized for all sectors of the economy as a complement to Table 1. An example of such a Sources Account for the petroleum section of Trinidad and Tobago 1966-1976, is shown in Table 6.

Requirements for Foreign Exchange Accounting

There are four main requirements to realise such Foreign Exchange Accounts:

1. Statistical

A primary input into F.E.A. will be data in a relevant form to facilitate the distinct categories noted above. This is not an easy task

Foreign Exchange Budget Classification

Table 1: F.E.B. Sources

<u>Source</u>	<u>Year</u>
1. Recurrent	exports of goods and services, F.D.I.
2. Non-Recurrent	loans, grants, F.D.I.

Table 2: F.E.B. Uses

1. Recurrent	debt repayment, investment income outflows, imports of capital, and intermediate goods, raw materials.
2. Non-Recurrent	travel, gifts, loans.

Table 3: F.E.B. Uses

1. Recurrent	
(a) Essential	e.g. foreign debt repayment, capital goods, basic food, drugs.
(b) Non-Essential	e.g. chicken and chips franchise

Table 4: F.E.B. Uses

1. Recurrent	
(a) Essential	
(i) Competitive	e.g. rice
(ii) non-Competitive	e.g. Wheat flour, transport equipment (buses, motor vehicles)
(b) Non-Essential	
(i) Competitive	e.g. chicken and chips franchise
(ii) non-Competitive	e.g. caviar, whisky

Table 4: F.E.B. Uses (Continued)

2. Non-Recurrent

(a) Essential

(i) Competitive

(ii) Non-Competitive electric turbine

(b) Non-Essential

(i) Competitive e.g. purchase of tickets from foreign rather than local airline

(ii) Non-Competitive e.g. apples and grapes.

Table 5: Net Foreign Exchange Supply of Major Sources of Foreign Exchange (Sector and Firm)

Source: Petroleum taxation, profits, wages and salaries

Uses: Profit repatriation, purchase of foreign goods and services.

TABLE 6

SOURCES AND USES OF FOREIGN EXCHANGE, 1966-1977

	\$'000 TT					
	1966	1967	1968	1969	1970	1971
	(1)	(2)	(3)	(4)	(5)	(6)
Current Account						
1. Gross Value of Export Sales ...	471,548.2	549,103.9	600,637.5	508,564.9	424,406.1	483,921.0
<i>of which:</i>						
(a) Exports of Manufactured Goods	417,707.6	499,080.1	541,131.7	448,994.4	365,237.1	425,797.4
(b) Exports of Services ...	53,840.6	50,023.8	59,505.8	59,570.5	59,169.0	58,123.6
Less						
2. Total Commodity Imports ...	43,597.8	36,134.7	39,199.1	44,515.9	72,396.2	92,774.1
<i>of which:</i>						
(a) Material Purchases ...	40,099.0	30,100.6	32,196.5	36,798.3	66,468.5	68,272.1
(b) Payments for Services ...	3,498.8	6,034.1	6,992.6	7,717.6	5,927.7	24,502.0
Equals						
3. Foreign Exchange Balance ...	427,950.4	512,969.2	561,448.4	464,049.0	352,009.9	391,146.9
Less						
4. Payments to Labour (Foreign) ...	1,761.9	1,982.6	2,106.6	2,335.9	2,814.8	3,379.2
Equals						
5. Other Foreign Exchange Available ...	426,188.5	510,986.6	559,341.8	461,713.1	349,195.1	387,767.7
Less						
6. Profits Remitted and Remittable ...	150,637.4	178,191.7	236,857.9	190,969.7	161,110.5	151,074.1
<i>of which:</i>						
(a) Royalties and Patents ...	40.0	35.0	35.0	34.2	32.8	32.8
(b) Interest and Bank Charges ...	2,967.5	3,984.4	5,051.5	6,828.4	9,273.2	7,983.4
(c) Management Fees ...	5,667.1	4,985.9	6,143.4	6,087.6	7,091.3	9,671.1
(d) Sales Expenses Accruing ...	4,157.6	4,661.5	5,063.7	5,071.3	4,769.5	5,295.2
(e) Depreciation ...	49,436.1	69,056.8	56,175.7	52,262.6	46,610.3	55,404.4
(f) Net surplus Less own Account Capital Formation ...	88,369.1	95,468.1	164,388.6	120,685.6	93,333.4	72,687.2
Equals						
Net Foreign Exchange Accruing to the National Economy on Current Account ...	275,551.1	332,794.9	322,483.9	270,743.4	188,084.6	236,693.6

Note that the totals given is the summation of only Exploration and Production, Refining and Petrochemicals for the period 1966-1975. For the period 1976 and 1977 the sub-sectors included are Exploration and Production, Refining, Petrochemicals and Bulk Distribution.

* Estimated.

Source: T & T Central Statistical office (1979)-Capital Accounts of the Petroleum Sector; 1966 - 1976 Table 14 pp 38-39

SOURCES AND USES OF FOREIGN EXCHANGE, 1966-1977 - Continued

	\$'000 TT					
	1972	1973	1974	1975	1976	1977
	(7)	(8)	(9)	(10)	(11)	(12)
Current Account						
1. Gross Value of Export Sales ...	599,139.3	908,831.2	2,235,405.4	2,897,240.4	2,933,143.3	3,647,631.4
<i>of which:</i>						
(a) Exports of Manufactured Goods	501,460.1	786,230.2	2,089,808.2	2,765,695.8	2,756,105.5	3,482,263.6
(b) Exports of Services ...	97,679.2	122,601.0	145,597.2	131,544.6	177,037.8	165,367.8
Less						
2. Total Commodity Imports ...	110,476.4	66,712.0	62,366.3	71,264.3	157,009.5	142,259.8
<i>of which:</i>						
(a) Material Purchases ...	71,049.1	54,987.4	51,865.6	59,313.4	107,662.3	103,755.9
(b) Payments for Services ...	39,427.3	11,724.6	10,500.7	11,950.9	49,347.2	38,503.9
Equals						
3. Foreign Exchange Balance ...	488,662.9	842,119.2	2,173,039.1	2,825,976.1	2,776,133.8	3,505,371.6
Less						
4. Payments to Labour (Foreign) ...	8,268.9	3,500.0 ^c	3,500.0 ^c	3,500.0 ^c	4,463.2	259.2
Equals						
5. Other Foreign Exchange Available ...	485,394.0	838,619.2	2,169,539.1	2,822,476.1	2,771,670.6	3,505,112.4
Less						
6. Profits Remitted and Remittable ...	184,888.3	383,351.0	703,971.1	1,035,120.6	977,456.8	1,268,578.5
<i>of which:</i>						
(a) Royalties and Patents ...	31.2	16.2	14.9	14.9	5,563.3	5,374.5
(b) Interest and Bank Charges ...	8,518.1	10,412.6	3,393.1	9,004.7	7,365.2	3,701.4
(c) Management Fees ...	10,172.4	10,567.1	12,284.1	12,978.9	10,386.8	6,056.1
(d) Sales Expenses Accruing ...	5,645.8	3,326.9	7,670.2	7,370.9	4,051.3	752.0
(e) Depreciation ...	94,708.0	78,763.0	106,612.9	108,640.5	235,872.8	294,502.3
(f) Net Surplus Less own Account Capital Formation ...	65,812.8	280,263.2	573,995.9	897,110.7	714,217.4	958,132.2
Equals						
7. Net Foreign Exchange Accruing to the National Economy on Current Account ...	300,505.7	454,268.2	1,465,568.0	1,787,355.5	1,794,213.8	2,237,593.9

Note that the totals given is the summation of only Exploration and Production, Refining and Petrochemicals for the period 1966-1975. For the period 1976 and 1977 the sub-sectors included are Exploration and Production, Refining, Petrochemicals and Bulk Distribution.

^c Estimated.

based on the present methods of collecting data in the current and capital accounts of the Balance of Payments. To devise an appropriate system will be a challenge to the information revolution specialists. The most obvious reason why data are not readily available is that no one devised an accounting framework which demanded such information. It may be impossible to develop 100 per cent accuracy in allocating sources or uses to these categories above - especially if such classification is based on existing trade data. However even partial accuracy could be an advance.

2. Input-Output Model

Foreign exchange accounting as proposed above is more than a simple post facto compilation of sources and uses of foreign exchange. Rather the F.E.A. groups sources and uses into analytical categories and projects such foreign exchange flows over a relevant time period. The purpose of the F.E.A. in this concept is essentially anticipatory thereby, permitting priorities of uses in the immediate short-run and allocation to most productive uses over the medium to long run. A vital adjunct to such F.E.A. is the availability of an input-output model of the economy. This can permit a more accurate estimate of the impact of allocation or non-allocation of foreign exchange to existing or proposed recurrent users of foreign exchange. Ally notes the limitation imposed by the absence of such a model at the onset of foreign exchange budgeting in Jamaica in 1977.⁴

"Ideally if we had at hand estimates of the import content of each sector's output, we would be able to say something about the effect of changes in intersectoral allocation of foreign exchange on real G.D.P. as a first estimation. The absence of an up-to-date import output table makes it impossible to take into account indirect import requirements of sectors and thus more precisely ascertain the effects of changes in allocation". (Ally, 1977, p 15)".⁵

3. A Legal Monitoring System

The establishment of legal and institutional mechanisms for reducing transfer pricing could achieve a substantial reduction in illegal foreign exchange outflow.⁶ Transfer Pricing reduces net foreign exchange available nationally by devices such as overpricing imports, underpricing exports, tax avoidance and evasion and fraud.

In the case of Trinidad and Tobago legal enactment is a matter of priority. A recent case supports this urgency. A national businessman pleaded guilty to fraudulently obtaining \$4mn(TT) equivalent in U.S. currency ostensibly to purchase imports. He was fined the royal sum of \$3000(TT). The head of the finance house also found guilty of aiding and abetting this businessman, was fined \$500(TT). Changes are needed in the relevant legislation to increase the mandatory penalties to punitive levels and reduce the discretionary power of the presiding judicial official.

4. Foreign Exchange Accounting Agency

Some existing institution must be given responsibility for foreign exchange accounting. In the Caribbean, the Central Bank seems the most appropriate institution. However other agencies need to be coopted such as the Ministry of Finance, Ministry of Industry and Commerce and the Customs Department, together with the Central Statistical Office.

Part B: Foreign Exchange Management

The projections of sources and uses of foreign exchange derived from the proposed accounting system then will serve as input into economic management. Projections should be for as long as 5-10 years, with greater detail for shorter time periods of several months to 2-3 years. Given the projected net balance of foreign exchange available, a number of management tools could be introduced. Such measures would be both on the demand side and the supply side i.e. affecting both uses and sources of foreign exchange. The remainder of this paper will concentrate on management policies on the Demand or Uses of foreign exchange side. In the final analysis it is the supply side which is more decisive. The focus on the demand side is not reflective of any disavowal of the need to generate foreign exchange. However it is felt that in the immediate future, Caribbean economies will not achieve any significant increase in foreign exchange earnings. There are several reasons for this.

Firstly, Caribbean economies are not presently structured to produce competitive exports of goods, and even new services. Even under best case assumptions, it will take several years to make these economies competitive.

Secondly, any recovery in the international economy is not likely to lead to any necessary growth in demand for Caribbean exports. The generalised recession of the last few years is the surface phenomenon of structural transformation in the developed, industrial economies. This will further reduce the possibilities for existing Caribbean exports for reasons developed elsewhere.⁷

Thirdly, the first impact of any export thrust by the Caribbean on the Balance of Payments, will be an increased demand for foreign exchange to purchase imported capital goods, technology and intermediate, if not new material inputs.

The two critical elements in foreign exchange management are Anticipation and Discretion. Anticipation will be assisted by the foreign exchange accounting systems. Discretion is indispensable to avoid loss of confidence in the balance of payments prospects of the economy. Once this happens, management becomes increasingly difficult as there will be an attempted run on the foreign exchange of the country. Prime Ministers and Central Bankers, therefore, are better advised to put in place the necessary measures before sounding the alarm.

The Jamaican experience is illustrative. Foreign exchange budgeting was introduced in Jamaica in January 1977. This followed current account deficits in 1975 and 1976 of \$257mn (Ja) and \$275mn (Ja) respectively. Foreign capital inflows - the traditional balancing item in Caribbean Balance of payments - declined from \$137mn in 1974 to \$77mn in 1975 and recorded a net outflow of \$31mn in 1976!

Ally notes that in January 1977: "The foreign exchange reserves of the country (Jamaica) were virtually depleted. The net international reserves stood at \$181mn". (Ally, 1977, p 6).

It was in this environment that balance of payments accounting and management was initiated in Jamaica.

Given projections of sources, a small economy may need to adjust uses - at least in the "short run" before sources can be increased. A number of management tools may be identified. These usefully can be grouped into three main policy measures:

1. Reserves policy
2. Micro-economic policy
3. Macro-economic policy.

1. Reserves Policy

Existing foreign exchange reserves need to be husbanded carefully as a buffer against balance of payments deficits.

2. Micro-economic Measures

- (a) Import duties on specific imports.
- (b) Import quotas on specific imports.
- (c) Negative list - restriction on certain imports entering the economy.
- (d) Non-tariff barriers which seek to either slow the level of imports or effectively put them on a negative list.
- (e) Exchange control.

Specific limits and/or requirements for prior permission for all or some uses of foreign exchange.

- (f) Foreign Investment Regulations.

The screening of FDI to areas considered necessary to achieve overall national socio-economic goals.

- (g) Technology Import Restrictions.

Screening of technology imports to activities consistent with socio-economic goals. One could include technology import decisions of both national and foreign investors. Such investors could be required to apply for permission once they will be recurrent users of foreign exchange. One key criterion for providing access would be their foreign exchange earning capability.

3. Macro-economic policy tools

- (a) Moral suasion - calls by the Government to the populace to reduce profligate consumption of imports.
- (b) An incomes policy to reduce disposable income and reduce the marginal propensity to consume imports.
- (c) Credit control to reduce imports by:
 - (i) higher downpayment limits on hire purchase;
 - (ii) shorter repayment periods on hire purchase;
 - (iii) general restraint in the growth of the money supply.
- (d) Devaluation of the currency.
- (e) External borrowing through:
 - (i) Multilateral agencies, e.g. IMF, World Bank.
 - (ii) Bilateral agencies, e.g. government to government loans.
 - (iii) International bank borrowing.

Assessment

Each of these management tools needs to be assessed properly, thereby deserving a paper in each turn. The point being made in this paper is that normally such tools are utilised only after a balance of payments crisis has descended on the economy. The advantage of the foreign exchange accounting system is that it will provide a projection of net external balance, thereby permitting anticipation. Depending on the seriousness of the projected balance, several of the above measures can be introduced, singularly, or in combination. In addition, however, on the assumption that the required data can be obtained, the accounting system will facilitate industrial planning. The FEA will identify which imports are recurrent, essential, competitive or

otherwise. Related sectorial policy, therefore, will be informed by this accounting system.

By its very nature, F.E.M., to be effective, must be anticipatory, discrete and complemented by other economic instruments. Short-run allocation of foreign exchange in the context of acute balance of payments deficits may be more appropriately defined as foreign exchange "slashing". Management assumes some rational control over uses and sources in the context of some flexible budget constraint. "Slashing" on the other hand, refers to an allocation to uses informed by the immediacy of external, unavoidable commitments. This normally involves drastic, sudden reductions in other uses which are not so much unnecessary as dispensable. Ally describes such a situation in Jamaica:

"We find that in 1977 future growth as determined by the importation of capital goods has to be given a lower priority than current output and employment, and capital goods have been curtailed....to permit a greater allocation to raw materials". (Ally, 1977, p 14).

Reservations

The cost of holding foreign exchange

The implicit assumption of the proposed scheme of foreign exchange accounting is that small open economies should hold or attempt always to hold substantial reserves of foreign exchange. The literature is unsettled on the question of what is ^{an} optimum level of reserves - particularly for developing countries. (Worrell, 1976; Niechans, 1970). In general one can suggest, however, that small economies will not find themselves with sufficient foreign

exchange earnings to need to devise an optimum level of holdings, except for relatively short time periods such as Trinidad and Tobago 1974-1983. In such surplus circumstances, foreign exchange expenditure should be no greater than the absorptive capacity of the economy. This requires identification of critical bottlenecks in the system. Whatever, "optimum", holdings result could benefit from Blackman's proposed five objectives of reserve management:

- (1) Liquidity
- (2) Income
- (3) Precautionary
- (4) Maintenance of value
- (5) Political considerations

(Blackman, 1981).

Control versus free market allocation

The proposal for foreign exchange accounting may be misinterpreted as a case for a closed economy which it is not. In fact, FEA, as proposed can be used in a variety of economic conditions. Such a distortion can be made particularly by those enamoured of the export manufacturing strategies of the so-called NICs. Those who perceive the free flow of market forces as the deus ex machina to the developmental problems in the Caribbean and elsewhere, tend to react automatically to any proposals which they perceive to involve foreign exchange restrictions. In the more extreme form, these free market advocates suggest that there should be no foreign exchange control!

The general view is that the success of the NICs can be explained by the free market models followed. A closer study of those countries which have developed successful export manufacturing sectors tends to belie this simplistic version. Japan was the first non-European economy to become a successful exporter of manufactures. If one examines this case carefully, one sees that two important pillars of the Japanese success story were legal and institutional mechanisms to control foreign investment and related technology agreements to activities identified by the Japanese as priorities. Generally these were in export generating sectors. Without using the term accounting and management therefore, one can suggest that Japan sought to allocate recurrent uses of foreign exchange into areas which would subsequently earn foreign exchange.

Fajnzylber indicates a similar implicit form of F.E.A. by the South East Asian manufacturing exporters:

"Contrary to what is suggested by the 'popular' versions, the trade policy followed by these countries has included a by no means insignificant import substitution component.... This careful and selective protectionist policy used both tariff and non-tariff mechanisms reinforcing both with measures regarding access to the foreign exchange market.... The authorization of foreign exchange for imports being conditional upon the generation of exports incorporating those imports, and thus involving the existence of institutional mechanisms permitting permanent communication between the government authorities and the respective enterprises".
(Fajnzylber, 1981, p 117).

There is some evidence to suggest moreover, that the foreign investors, whom some may fear accounting will scare away, do in fact make

their own independent calculation of the particular economy's capacity to sustain repatriated profits. Gabriel notes in a study of the behaviour of transnational corporations that:

"In any case these are distinct limits to the capacity of a country to absorb foreign direct investments. Some of these limits are economic. Many of the less developed countries, for example, are increasingly unable to service the foreign exchange liabilities associated with a continually growing stock of foreign-owned capital". (Gabriel 1972, p 9).

The fact of foreign exchange accounting does not imply necessarily a very restrictive exchange control regime but simply the availability of an accurate picture of foreign exchange flows over a relevant time period. Mattera reports for example, that foreign exchange "budgeting" was widely used in Latin America in the immediate post World War II period, but for a variety of purposes from the mere statistical to instruments for restricting exchange transactions. In fact, the IMF advised some of these Latin American countries initiating foreign exchange budgets. (Mattera, 1954).

Is Exchange Control Foreign Exchange Management?

Given the fact of Exchange Control regulations in Trinidad and Tobago and elsewhere one can conclude that foreign exchange management already is practised; supported by legal and institutional mechanisms. Foreign Exchange control (F.E.C.) is necessary for FEM but by itself is not sufficient to guarantee any optimum management of foreign exchange flows. For one thing FEC focusses primarily on uses and does not take into account existing and projected sources of foreign exchange. Secondly FEC does not

include perhaps the most important longer-term causes of B-O-P disequilibrium-investment decisions which set in train recurrent uses of foreign exchange by sectors which earn virtually no foreign currency, e.g. the assembly manufacturing sector.

In some instances foreign exchange ceilings appear to be established on somewhat arbitrary bases. The best example being that of allocation to foreign travel. On what criterion does one arrive at a sustainable allocation overtime? One way to sensitise the population to the foreign exchange issue would be to determine the foreign travel allocation at the beginning of each fiscal year on the basis of savings from the previous year.

In general, therefore, one can suggest that FEC is an extremely weak form of FEM and one that will be completely ineffective in terms of anticipating or resolving B-O-P crises, as the Jamaican experience illustrates. In addition to the general limitations of FEC, as a proxy for FEM, the Trinidad and Tobago practice of FEC exhibits a number of other weaknesses. The legal penalty for foreign exchange manipulation clearly is not punitive and also gives the presiding judicial officer too much discretion with all the possible ramifications. Secondly, the monitoring system is extremely weak. The Central Bank itself perhaps provides the most rigorous scanning of foreign exchange outflows which it directly handles. The signatures of two Foreign Exchange Control Officers are necessary, thereby

requiring complicity in any fraudulent conversion. The Exchange Control Division has recently begun to computerise its operations thereby permitting a more efficient basis for determining recurring applications over time. However, the Central Bank's FEC Division directly handles only an approximate 25 per cent of total foreign exchange outflows since it deals solely in payments for services including outflows on the Capital account. The control over the major proportion of foreign exchange outflows in payment for imported goods is delegated to the Ministry of Industry and Commerce. However, in the latter Ministry only one authorised signature is necessary to permit approval for foreign exchange outflow.

The Trinidad and Tobago Central Bank now limits the discretion of the Ministry of Industry and Commerce to a maximum of \$100,000 TT. Nothing I have seen indicates that there is also a maximum number of such allocations which can be given to any individual and firm per year. Therefore, 10 approved forms will give an applicant \$1mn TT.

TABLE 1.39

BALANCE OF PAYMENTS, 1979-1983
(Dollars Million)

I T E M S	1979	1980	1981 ^r	1982 ^r	1983 ^e
(1) <u>Merchandise (net)</u>	<u>359.5</u>	<u>1,434.1</u>	<u>1,216.7</u>	<u>-1,360.4</u>	<u>-1,116.9</u>
Exports	3,957.1	6,205.3	5,988.5	5,306.9	4,899.1
Imports	3,597.6	4,771.2	4,771.8	6,667.3	6,016.0
(2) <u>Services (net)</u>	<u>-337.0</u>	<u>-332.1</u>	<u>-247.7</u>	<u>-392.8</u>	<u>-994.1</u>
Transportation ¹	317.2	470.1	305.4	228.5	47.4
Travel	43.5	27.5	-37.0	-205.2	-240.1
Investment Income	-587.9	-722.4	-315.6	-42.9	-178.0
Other Government	12.3	8.8	-14.1	22.6	31.3
Other Services	-122.1	-116.1	-186.4	-395.8	-654.7
(3) <u>Unrequited Transfers (net)</u>	<u>-109.5</u>	<u>-157.2</u>	<u>-217.7</u>	<u>-263.7</u>	<u>-250.3</u>
(4) <u>Current Account Balance</u> (1)+(2)+(3)	<u>-87.0</u>	<u>944.8</u>	<u>751.3</u>	<u>-2,016.9</u>	<u>-2,361.3</u>
(5) <u>Capital Account</u>	<u>995.1</u>	<u>541.7</u>	<u>609.6</u>	<u>1,131.7</u>	<u>686.3</u>
Direct Investment	416.5	328.8	487.9	637.4	250.6
Other Private	444.1	49.6	206.6	262.9	268.2
Official Borrowing	132.2	147.5	35.7	224.2	208.1
Official Loans	-	7.9	-179.6	58.1	6.7
Other Official	2.3	7.9	-	-50.9	-47.3
(6) <u>Allocation of SDR</u>	<u>26.0</u>	<u>26.0</u>	<u>26.0</u>	=	=
(7) <u>Errors and Omissions</u>	<u>-47.1</u>	<u>-13.6</u>	<u>-36.4</u>	<u>+358.1</u>	<u>-492.6</u>
(8) <u>Overall Surplus(+)/Deficit(-)</u>	<u>+887.0</u>	<u>+1,498.9</u>	<u>+1,350.5</u>	<u>-527.1</u>	<u>-2,167.6</u>
(9) <u>Change in Reserve(=-increase)</u>	<u>-887.0</u>	<u>-1,498.9</u>	<u>-1,350.5</u>	<u>+527.1</u>	<u>+2,167.6</u>
Government	-1.1	-1.1	+1.1	-2.8	-0.3
Monetary Authorities ²	-821.2	-1,549.5	-1,373.7	+522.9	+2,099.4
Commercial Banks	-73.7	+51.7	+22.1	+7.0	+68.5

SOURCE: Central Statistical Office
Central Bank of Trinidad and Tobago

¹ Includes Freight

² Includes Central Bank holdings, IMF Reserve Tranche and SDR holdings.

^e estimates

^r revised.

ENDNOTES

1. For a useful discussion of the concept of smallness in the Caribbean context, see T.M.A. Farrell (1979).
2. In Jamaica and elsewhere, the term foreign exchange budgeting is used in two senses. Firstly to mean foreign exchange accounting as defined in this paper. Secondly in the sense of using the information gleaned from some projection of net foreign exchange availability, however determined, for budgeting or allocating foreign exchange sources. There is some confusion in the literature, therefore, on the particular sense in which the term Foreign Exchange Budgeting is being applied. Hence this author has sought to clearly demarcate the gathering of information on projected net foreign exchange available - termed foreign exchange accounting - from policy measures possible for resolving potential deficits - i.e. foreign exchange management.
3. The categories, essential and non-essential, competitive and non-competitive have been borrowed from Best and Levitt (1968).
4. See endnote 2.
5. Jamaica now has developed such an input-output model which is used by the Bank of Jamaica, in conjunction with the National Planning Agency, in determining the foreign exchange budget.
6. Part Three of Murray ed. (1981) provides a useful approach to such monitoring.
7. See D.A. Pantin (1984).
8. See endnote 2.

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