The Foreign Exchange Constraint on Monetary Policy: The Bahamian Context

Remarks by
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Good evening.

It is a pleasure for me to bring opening remarks for this distinguished panel of past Central Bank Governors, all of whom I know and have worked with in some professional capacity.[2] The common theme in these professional encounters was the appreciation of the scope for which monetary policy could be effective in either a Bahamian or Caribbean setting; what contributed to making policy effective; and the understanding of what constrained policy makers.

In The Bahamas, we have a commitment to maintain a fixed exchange rate, at one to one against the US dollar. The exchange rate peg is supported by the foreign reserves of the Central Bank. By law, the currency liabilities of the Bank must be matched, at all times, by at least half the equivalent amount of foreign reserves. At present, the Central Bank tries to target this coverage in the range of 90% to 100%.

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[1] As prepared for delivery.

[2] I was introduced to Sir William Allen in 1988 in my first tour as a summer intern at the Central Bank of The Bahamas. After Governor James Smith joined the Bank, I remember detailed comments he provided on a policy paper I wrote about options for monetary integration in the Caribbean. Those comments are still relevant today. During Governor Julian Francis' tenure, I interacted on many occasions with him about adjustments to exchange controls and monetary policy, including policies which we embraced in the immediate aftermath of the September 11, 2001, terrorist attacks on the US. In fact, Governor Francis' queries motivated most of my research on dollarisation and exchange control liberalisation. Governor Wendy Craigg and I have had the longest relationship of all, as she managed the Research Department, where my central bank career began, and we both attended regional conferences, where I present papers on the pressing monetary policy themes facing the Caribbean.

For the peg to be credible, the Bank must always be able to supply foreign exchange at the guaranteed rate. Under our exchange control regime, this guarantee is binding for all trade and current account transactions.[3] To ensure credible access to foreign exchange, the Bank seeks to balance inflows, principally from export earnings against demand stimulated outflows from income, drawdown of savings and domestic credit financed activities. The lever most controlled by the Bank is domestic credit. It is focused not on whether credit can stimulate economic activity, but on whether the credit generated can be sustained, given the first imperative to maintain adequate external reserves.

In the aftermath of the September 2001 attack on the US, the optimal policy response was to freeze the supply of domestic credit, and to tighten lending standards. This was a contractionary or procyclical policy response. When the foreign exchange inflows improved, credit conditions were relaxed, also in a procyclical fashion. This episode illustrated, what is generally the case for The Bahamas-- protecting the value of the Bahamian Dollar, leaves little sustainable space for monetary policy to be growth enhancing in the short-run.

Developments in the fiscal domain also affect the monetary policy space. As a general proposition it is neither advisable nor sustainable in a fixed exchange rate regime to have unchecked deficit financing by the monetary authority. These can perpetuate currency base expansion without the corresponding increase in foreign reserves that provide the coverage for the currency.[4] Fiscal deficits can also can fuel increased imports, which drawdown on foreign reserves.

At the instance of a deficit, monetary policy is therefore most concerned about how the deficits will be financed. The reference point is not the amount of domestic liquidity against which the government might borrow, but the amount of foreign exchange that the economy would require to pay for the resulting increase import demand. Given this consideration, the Central Bank's advice is usually that deficits must be financed with some amount of foreign borrowing. Otherwise, the effect would be a drawdown in foreign reserves and undermined support for the currency.

The preventive measure is limiting the occurrence of deficits, in the first instance, as often the choice of how the deficit will be financed is an artificial one.

There is nevertheless a medium-term concern about the level of liquidity in the Bahamian financial system. To address this, the Central Bank's forward looking strategy is to gradually reduce the outstanding lending to the government. This would absorb any excess liquidity that had its origin in accumulated past central bank financing of the government.[5]

Where does all of this leave us in terms of improving the environment for monetary policy, and making it less procyclical?

First, over the medium and longer term, the economy has to do a better job of retaining the foreign exchange that it earns. More bank lending has to reach productive enterprise activities that forge

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[3] Over time, liberalisation of the regime has also allowed greater access to foreign exchange to support more outlets for savings and investments that expand the country's longer-range capacity to earn foreign currency.

[4] The other instances that drive expansion in the currency base are purchases of foreign exchange from public and private sector activities. These produce a one to one growth in the reserves and create no tension in the external reserve backing for the domestic currency.

[5] Liquidity is also created when the private sector takes in more foreign exchange than it uses. Such excesses flow from commercial banks to the central bank. In the process, the central bank issues new domestic currency liabilities. This is liquidity that can support demand and credit growth without unease about the cover for exchange rate stability.

linkages with tourism, provide competitive substitutes for imports and expand our export reach. The Central Bank's targeted liberalisation of capital controls, has also allowed such categories of enterprises direct access to financing in foreign exchange. We believe that it is a strategy that will bear fruit over the medium-term.

Second, the fiscal policy framework has to bolster support for the currency. Deficits, when they arise, should anchor public investments with positive net returns to economic growth, and have a positive foreign exchange bias. More fundamentally, for our present circumstances, deficit reduction and eventually budget surpluses should become the order, with more public investments sustained from savings on recurrent expenditures. Fiscal deficits and debt accumulation, can make it difficult to wean the government off borrowing from the monetary authority; and in parallel, can expand foreign currency debt in ways that cannot be easily repaid.

Better foreign exchange retention and confidence engendered by fiscal policy, takes us to the topic of exchange controls. Some rebranding is necessary to make this more of a conversation about capital controls and capital flow management. This is essentially where our policies are more binding, but where scope for very gradual targeted easing is possible over the medium-term. The limit though is to understand that liberalisation cannot happen out of a sequence of first having in place lasting policy and accountability frameworks that bolster investor confidence. Where these frameworks are missing or nascent, liberalisation must impose a distinction between how we deal with direct investments versus very liquid, and highly sensitive portfolio flows.

If the end goal is to have fully liberalised capital flows, then we must accept that it would come with a floating Bahamian dollar. If we float, we should want to avoid the exchange rate volatility that arises when investors become jittery.

If we dollarise to eliminate currency volatility concerns, then fiscal and private sector savings will remain important to provide the buffers needed to make our economy resilient. Dollarisation will not provide a shortcut out of reforms that are needed--in terms of utilising less direct means of influencing credit and investment behaviour to safeguard financial stability; having more comprehensive real-time data on economic activity, including fiscal indicators; having a larger stock of foreign reserves to cushion against shocks, and the like. Dollarisation would still be premised on a target value for the exchange rate at the time of the domestic currency's abandonment. This again raises the question of whether such an outcome could be achieved absent an effective capital flow management regime.

There is much more than can be said on this topic and on other dimensions of the Central Bank's role, beyond the protection of the currency. The Bank has been working tirelessly in all of those dimensions: strengthening the quality of our regime for supervised financial institutions; accelerating the modernisation of the domestic payments system; laying foundations for use of more indirect monetary policy instruments and building more capacity for macro-prudential supervision. We realise that it is only through lasting structural reforms that there would be progress in making the monetary and financial system a stable, more resilient and a less procyclical component of our growth and development.

It is fitting therefore to have this esteemed panel assembled, and I look forward to hearing their views on this important topic.