C E N T R A L   B A N K   O F   G U Y A N A

RESEARCH DEPARTMENT

FOREIGN EXCHANGE BUDGETS: THEORY & PRACTICE

by

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INTRODUCTION

Like all Less-Developed areas, the Caribbean region has always been plagued by Foreign Exchange problems. They became more acute as a result of the oil price increases of the period 1973/74 and seemed to disappear as high sugar prices prevailed in the world markets during 1975. In 1976 however, the problems were more serious than ever, as balance of payments deficits on current account increased alarmingly, and especially so in Jamaica and Guyana.

The seriousness of the disequilibria in the external sectors of these economies was such that both countries decided to embark on a Foreign Exchange Budgeting exercise with a view to allocating their scarce foreign exchange resources by means of quotas to importers. The consequence of the exercise by these two countries have given rise to much acid comment on both sides. Exporters in the 'non-Budget' countries have come out in force in favour of some sort of retaliation against the exports of Jamaica and Guyana, who in turn have been trying to show that the effect of their restrictions are somewhat overstated by their detractors. Some commentators have even predicted that the Budgeting exercise and the dangers to intra-regional trade which it presents, will eventually lead to the demise of Caricom itself.

This paper concerns, for the most part, Guyana's experience with the Budget and some of the lessons it has learned from that experience. The first part of this paper briefly describes the 'Payments' approach to balance of payment correction and attempts to place the foreign exchange budget in this framework. It also shows some of the pitfalls which need to be avoided in implementing a foreign exchange budget and is based on a past experience of countries which have used this method of correction.

Part two recites the Guyana experience with Foreign Exchange budgeting and finally a part three gives a preliminary evaluation of the budgeting exercise by Guyana.

The "Payments" approach views the balance of payments as the relation between aggregate expenditure and aggregate receipts in the economy. Thus B = Y - A

where, B = Exports less imports

Y = National Income

A = Consumption & Investment i.e. Expenditure

This can be re-written:

B = R - P

where, R = aggregate receipts, and

P = aggregate payments

From this equation it can be seen that a deficit in the Balance of Payments will arise if aggregate payments exceed aggregate receipts.

Since a country cannot continue indefinitely to maintain a disequilibrium in the balance of payments then corrective action is needed. The authorities must either reduce the level of payments (P) or increase the level of receipts (R).

The choice of tool used to correct the disequilibrium is dependent on the original cause of the disequilibrium, whether or not the imbalance is temporary, the underlying behavioral relationships in the economy, as well as the size of the foreign sector gap.

The authorities may use either specific measures to affect the price and or quantum of foreign exchange utilised during the period. That is they may act directly to reduce the level of the Balance of Payments gap by switching expenditure from foreign to local sources, and, or, they may act on the total level of aggregate expenditure via the central government budget on the fiscal side or through credit adjustments on the monetary side.

On the fiscal side a higher level of tariffs tend to increase the domestic price of foreign exchange while licences on merchandise trade and quotas tend to limit its quantum. On the monetary side exchange rate changes affect the price of foreign exchange. Advance deposits on imports are usually imposed to reduce the attractiveness of imports via increasing the cost of financing, while exchange controls aim to limit the quantum of foreign exchange flows.

While much has been discussed in the literature on the use of demand management and exchange rate movements as a corrective device, little has been said in terms of the use of exchange controls. This paper aims to make a more thorough examination of this tool.

Exchange control regulations aim to increase the level of foreign receipts by implementing measures to ensure that the maximum of income earned abroad flows back into the system. On the payments side it seeks to control the level of outflows which leave the system. It is in the performance of these functions that the foreign exchange budget is prepared. Similar to budgets prepared in other economic and commercial spheres the foreign exchange budget serves as an indicator of possible revenues and expenditures over a given period of time. It attempts to estimate the level of foreign inflows arising from visible and invisible exports, transfers and capital receipts, and at the same time it attempts to predict the level of outflows via imports and capital repayments.

Thus the budget serves as an early indicator to authorities for the need to accommodate a gap either by borrowing, by utilising reserves, or on the other hand to use corrective action to bring the gap to a level closer to one which the resources could support. Thus the foreign exchange budget serves mainly as a guide to overall financial policy.

There has been a tendency to regard foreign exchange budgeting as simply a more elegant way of expressing a system of rigid quantitative import restriction, and hence the exercise has been associated with shortages and rationing of commodities. While in terms of Balance of Payments the budgeting operation may give rise to the fixing of quotas by the authorities either to firms or to sectors, its usefulness is not to be inextricably associated with Balance of Payments crises. Rather it is probably even more beneficial when implemented in non-crisis situation, where Balance of Payments considerations are not paramount and when technicians and policy makers have the time to set out other national goals. In periods of foreign exchange crisis, attention is placed almost solely on the foreign sector of the economy, thereby tending to neglect its feedback effects on the domestic sectors. It is this neglect which results in so many of the distortions associated with foreign exchange budgeting.

Unfortunately the identification of economic distortions with foreign exchange budgets within the region has been strengthened by the fact that both Guyana and Jamaica made no serious attempt to implement a foreign exchange budget until faced with a Balance of Payments crisis. Until this stigma is removed, general acceptance, by individuals and the business community, vital to the efficient performance of the budget, will not be forthcoming.

The aim of budgeting in a crisis is to close the foreign exchange gap by placing direct controls on the level of outflows and at the same time it aims at allocating the scarce foreign resources in order of the priority requirements of the economy.

Theoretically in terms of its expenditure switching role, this tool is similar to a devaluation. However in devaluation the system depends on the price mechanism to achieve the switch and to reallocate the resources. In both cases the maintenance of internal stability is dependent on the economy's capacity to increase the level of output. Without an increase in output the achievement of external balance may well be at the expense of internal stability.

In cases where the level of foreign exchange resources is very low it is argued that one cannot depend solely on the market response to the price stimulus to bring about a closure of the gap in the foreign sector. Further, it is argued that the choice of a foreign exchange budget as against a devaluation as an allocative device has implicit in it that the market mechanism gives rise to allocations contrary to the national interest, and that a direct mechanism will instead distribute this scarce resource in a manner more conductive to the development of the economy.

If the foreign exchange budget is adopted as the tool for allocation, what first needs to be determined is the maximum level of resources available for allocation. Thus some attention would have to be focused on the supply side of the foreign exchange budget. Foreign exchange earners must be given production targets to be achieved and a monthly analysis of the variances between actual and targeted production be made in order to determine whether shortfalls are the result of price fluctuations or reduced levels of production. It is only by such close scrutiny of the supply side of the foreign exchange that the budget can serve as a means of encouraging production and a higher level of inflows.

Having determined the possible level of inflows, the question now arises of how the foreign exchange is to be allocated. Government and the economic planners will have a hierarchy of priorities consistent with the D-plan and it is on the basis of these that the resources are usually allocated. Topping the list of priorities are usually payments for food and other essential commodities such as fuel, repayment of loan capital and interest, especially with respect to Government guaranteed debt, and essential inputs, including machinery for export industries, not necessarily in that order.

However, the avertion arises as to how efficient the budget can be in performing these allocative functions. In its aim to achieve the target of efficient distribution in the external sector there will be an internal cost, which, if not minimized may lead to serious disruptions in the economy. Some of the more important of these are the following:-

(i) The budget of itself may not cause an increase in the level of import prices, nevertheless domestic price effects of foreign exchange rationing are likely to be quite substantial and the burden will be passed on to consumers unless strict price control of basic commodities is undertaken by the Government. Price effects arise from the fact that allocation by phased rationing of foreign exchange is not fully synchronized with the demand pattern of consumers. As a result the pressure of excess demand for these imported commodities on a limited supply, forces up the market price, with concomitant effects on real income. Price controls often fail to prevent the formation of secondary markets in these commodities which do reflect true market prices. Further, because the items are usually of high price-elasticity, the inflationary effects of foreign exchange rationing are to be carefully considered in planning the Budget. Needless to say, with higher prices, come trade union demands for higher wages and salaries, further aggravating the already substantial inflationary pressures.

(ii) The allocation of foreign exchange by means of a foreign exchange budget has important consequences on production and industrial strategy. One of the targets which the foreign exchange budget sets out to achieve is to maintain the level of activity in the productive sector. In this case priority is usually given to intermediate goods for use in these sectors. However, when the budget constraint is high i.e. the level of resources available for distribution are very low, then the aggregate demand for raw materials and other imported inputs may well outstrip the supply allowed by the allocation. Usually, within the manufacturing sector priority is granted to the industries which are the major export earners.

It follows therefore that for the rest of this sector, foreign exchange will be in short supply, and cutbacks in production will result. Unfortunately it is in this group that small manufacturers and minor exporters fall, and it is therefore in this category of manufacturers that most of the burden of the foreign exchange rationing falls. Direct allocation of foreign exchange via the Budget may well give rise to a conflict of objectives between national priorities, viz. the promotion of small scale industries and export promotion. An appropriate balance of emphasis between these aims, no matter how elusive, must be sought if benefits gained in one area are not all to be dissipated in another.

(iii) The complementary fall in employment consistent with reduced levels of output, and a lower level of industrial activity, in general, are consequences which must be anticipated in planning the foreign exchange Budget. In periods of normalcy, some unemployment may result in those enterprises which are not engaged in activities of national economic priority, such as distribution, and the manufacture of "non-essentials." In periods of crisis in the Balance of Payments, and therefore of less foreign exchange availability, production and employment levels deteriorate much faster, with multiplier effects on income and economic activity in general. The inclusion of employment levels in the list of criteria for allocation of foreign exchange is perhaps one means of alleviating the problem, but here again conflicts of objectives may arise between encouraging production in the export, or import-substitution sectors, and that of raising employment levels. In countries where average rates of unemployment are already high, a budgeting programme which places the greatest emphasis on the avoidance of aggravating the level of unemployment is vital.

(iv) Johnson has argued that by adopting direct controls instead of an explicit tax on non-essential imports, policy-makers miss the opportunity to appropriate in taxes the scarcity value of non-essential imports created by rationing. Instead, the scarcity value accrues to recipients of import licenses for these commodities. This situation must run counter to both social and economic policy. In planning the budget therefore, a quantitative analysis needs to be made of tax receipts foregone as against benefits to be derived by a direct form of foreign exchange allocation.

(v) In many countries the use of the foreign exchange budget as a means of saving foreign exchange is seen as a booster to their industrial plans for developing import substitution industries. In these countries e.g. Ghana, India and Turkey, this has been reported to be one of the prime causes of a failure of the foreign exchange budget.

The potential distortive effects of foreign exchange allocation by rationing on Industrial Strategy needs to be carefully avoided by the policy makers. The scarcity of imported commodities which are in great demand and these include non-essentials, has been an incentive to substitution of these commodities from domestic resources. Usually, import substitution industries are given positive encouragement by the government with a view to expanding local industries, incomes, and employment levels. However, not only is it necessary to import substantial amounts of the essential inputs into the industries, so that whatever foreign exchange gain there is, needs to be netted out, but also because of the subsidy implicit in the allocation of foreign exchange to import-substitution industries, domestic resources such as skilled labour, and savings, are diverted towards them. On the other hand, because of the absence of a scarcity value attaching to such essentials as food on account of their high priority in the Budget, domestic resources tends to be switched away from these industries and into those concerned with import substitution. The undesirability of this pattern of Industrial Strategy is clear in a region such as ours. Therefore great care must be exercised in order to ensure that the country's import substitution programme is not abused by unscrupulous manufacturers and to ensure that adequate resources, both domestic and foreign, and encouragement are channelled towards the manufacture of such essential items as food and clothing. Failing this, the industrial pattern which emerges will tend to perpetuate, rather than relieve pressures on the foreign reserves.

Apart from its effects on prices, income, employment and industrial strategy, foreign exchange budgets have been severely criticised on administrative grounds. Primarily because decision making lies in the hand of a group of administrators, systems have been devised in many countries to limit the possible abuses which could occur should corrupt persons fill those positions. These checks in the system have tended to lead to a proliferation of bureaucratic allocational procedures. In many cases bottlenecks have occurred and consequent shortages in system due to delays involved in the processing of documents for the quota releases. The direct allocation of foreign exchange by an administrative machinery operating under such constraints as the lack of adequate information on the inter-relationships between the foreign and domestic sectors, and a constant pressure by importers and consumers to make ad hoc decisions, of necessity will give rise to such inefficiencies. To a large extent this type of problem could be avoided if a foreign exchange budget is prepared sufficiently in advance of the period in which it is effective.

It will be observed therefore that unless these internal repercussions of foreign exchange rationing are anticipated and corrected, the net benefits to be derived by the nation as a whole from the pre-occupation with the Balance of Payments connection to the exclusion of other domestic variables might well be small. This result arises in most situations where economic problems are approached on the framework of a partial analysis. The tendency to perceive foreign exchange budgets as a tool only of Balance of Payments correction, instead of integrating it within a general framework consisting of other fiscal and monetary tools with a view to achieving simultaneous equilibrium in all sectors of the economy needs to be strictly discouraged. The most important single criticism by the monetarists of direct controls is that it adopts a partial equilibrium approach, to the neglect of feedback effects on the rest of the economy. Both economic theory and bitter experience of the many countries which have practised rigid foreign exchange budgeting stress the economic distortions which occur when a partial approach is adopted.

Perhaps therefore, the single most important task of policy-makers in framing the budget is to ensure that a more comprehensive approach to the budgeting exercise is undertaken - thereby ensuring that the foreign exchange budget links smoothly with the exercise of national planning for the domestic sectors. Thus at the same time that attempts are made to conserve foreign exchange, domestic savings must be encouraged, higher surpluses need to be generated by Government corporations, and the Central Government Budget deficit needs to be reduced.

THE GUYANA EXPERIENCE

A very rudimentary form of foreign exchange budgeting has been practised in Guyana since 1973. It takes the form of projecting on a monthly basis, receipts and payments expected to flow through the Banking System. On the receipts side, projections are made of receipts expected from the major export earners such as the sugar and bauxite industries, and of other miscellaneous receipts. On the payments side projections are made of expected merchandise and service payments. These projections are compared with actual monthly receipts and payments and a short analysis is made of the variances.

In this form the budget serves only as a guide to expected levels of receipts and payments and therefore to the possible movement in the international reserves. Since export receipts are for the most part regarded as exogenous, the power of sanction is confined almost entirely to import payments which are controlled by the Central Bank. Since there existed little Central Bank intervention in import licensing, the value of this type of Budget was confined almost entirely to 'ex-post' analysis of adverse variances on import payments.

At the end of 1976, however, a critical Balance of Payment position developed as the deficit on current account moved from \$35 million in 1975 to \$351 million. With net capital inflows mobilized of only \$114 million, the International Reserves plunged by around $240 million. Forecasts for the year 1977 all predicted that it indeed would be a challenging period for the policy-makers. Projections showed no significant lift in level of external earnings and indicated that reserves were at a level which was much too low to sustain the current rate of growth in expenditure. A review of the monetary policy indicated that ex-post attempts to limit the growth in aggregate demand via credit restraint had not met with much success. In terms of the Guyana banking system the credit controls merely served as a way of reallocating credit from the private sector to the public sector. While the commercial banks complied with directives in limiting their loans and advances, the excess resources released were immediately utilised in purchasing Central Government Treasury Bills - thereby increasing the level of credit to Government. To the extent that the central government seemed to have almost limitless access to the recourse of the central bank to finance its budget deficits, it seemed that a contraction in the level of aggregate demand could occur only if a conscious decision was made by the Central Government to close the gap between its receipts and payments or to find financing from external sources. This implied that to close the gap the Government would either have to increase taxes or to reduce the level of expenditure. Borrowing from external sources would have helped to support the existing level of governmental activity, as well as buoy the level of foreign reserves though in the long run increased debt repayments could have placed an even heavier burden on the economy. However, borrowing was not forthcoming in the magnitude required. On the receipts side an increase in the level of taxation seemed inappropriate since the economy is already carrying a heavy tax burden in almost all areas of economic activity. Therefore it seemed that the adjustment had to be made via a reduction in the level of expenditure. But it seemed, in the light of existing policy aims of making basic ammenities available, subsiding the cost of living and at least maintaining current employment levels, that there was not very much scope for substantial reduction either current or capital expenditure. In the light of the foregoing it was therefore not surprising that there was a considerable balance of payments gap as much dependence was still being placed on the banking system to finance the central government deficits. Attention was therefore focused on reducing the foreign sector gap via a more direct method.

OPERATION OF THE SYSTEM

All major users of foreign exchange, including Government Ministries and Agencies and Importers, were requested to submit to the Bank a breakdown of their foreign exchange requirements for 1977. For example, large importers were to list the type of merchandise, or services to be paid for in foreign currency. In addition to these written submissions, most of the major users of foreign exchange, accounting for a substantial percentage of the foreign exchange used in 1976 were interviewed by the Bank, with a view to having a first hand knowledge of their operations, the nature of their contribution to the economy, and their minimum foreign exchange requirements. It needs to be stressed that interviews were not confined only to the large importers, they also catered for small manufactures with turnovers of around $25-50,000.

Within this framework of fairly comprehensive information concerning the foreign exchange needs of the economy, and the potential feedback effects on the domestic sector of reduced foreign exchange availability, the Bank made allocations on a "transactor" basis to all the entities with which it had been in contact. The total amount of foreign exchange allocated was based on Central Bank projections of export earnings, and external loans, credits and grants for 1977. Essential items were classified as food, drugs, spare parts and fuel. With respect to invisible imports, repayment of loans satisfied the essentiality concept. Quotas were determined on the following criteria:-

(1) The type of activity engaged in by the firm:- firms which were important export earners, such as the Bauxite, Sugar and Rice Corporations were given the highest priority - the objective being that they should not be deprived of vital machinery and other equipment in their effort to boost export earnings.

At the other end of the scale were, for example, firms engaged in the distribution of non-essential imports such as hi-fi and stereo equipment.

(2) The average turnover and the number of employees, of the firm:-

Having satisfied the first criteria, an attempt was made to grant quotas in such a way as to cause the minimum cutback in production or sales. Serious cuts would have the effect of damaging the firm seriously, or perhaps even permanently. The number of employees was regarded as an important criterion for obvious social and national economic policy reasons.

(3) The growth potential of the firm with respect to generating foreign exchange, income and employment.

36% of total allocations were made to Government Ministries and Corporations, 27% to the major export earners - sugar, rice and bauxite, 25% to other small exporters and manufacturers and 14% to the remaining transactors.

Simultaneous to the issuing of these allocations, the Central Bank assumed an equal role with the Ministry of Trade in the approval of licenses. Licenses are now first submitted to the Ministry of Trade, where they are assessed for compliance with national policies and are ranked according to the essentiality or non-essentiality of the commodities required. They are then routed to the Central Bank where a check is made that the amount on the licenses are within the importer's quota.

No restriction was placed on the use of the foreign exchange once granted except that it should pay for goods for which there was a valid import license, and that on account of the seasonality in sugar exports, only one-third of the quota could be used for import payments in the first half of the year, the remaining 2/3 being available in the second half. Importers were to submit to the Bank one week beforehand, a schedule of their payments coming due in any particular week, so that the reserve situation could be anticipated.

A certain degree of flexibility was built into the budget in so far as importers who found themselves faced with changing and difficult circumstances, or exporters who needed a supplementary allocation in order to meet and retain a lucrative market were asked to apply to the Bank, which promised to be sympathetic in spite of the fact that it was operating under extremely difficult circumstances.

EVALUATION TO DATE AND LESSONS FOR THE FUTURE

Eight months of operation is much too short a period to evaluate fully the performance of Guyana's experiment with foreign exchange budgeting. Nevertheless, we are able to do at least a preliminary analysis which should prove useful in our future operations with the exercise.

In terms of achieving a targeted rate of change in the level of foreign reserves, the budget has performed fairly well. By the end of the first six months of the year, the actual change in reserves exceeded the budgeted change by a mere G$2 million. In terms of individual allocations, apart from a few exceptions the actual use of foreign exchange has varied only minimally from quota allocations.

The effect of the Budget on the Balance of Payments for the first half of the year also elicits some encouragement. While the deficit on current account shows little improvement over the level in the corresponding period in 1976, non-oil imports have been reduced by $43 million.

However, apart from these two encouraging indicators, a cursory analysis of the budget reveals several shortcomings. In the first place it now seems clear that our initial estimate of man hours required to put the Budget into operation was too low. The preparatory work involved countless hours involved in contacting transactors, verifying their submissions especially with respect to historical import levels, and interviewing them. Even after all this was completed, importers previously unknown to the Bank, descended on the institution after it became widely known that a foreign exchange Budget was in preparation. In retrospect it now seems that not enough time was devoted to this preparatory stage, although the haste can perhaps be understood in the context of our precarious financial position.

Again, primarily on account of the haste in which the exercise had to be completed, the spin-on effects of the severe restriction on foreign exchange payments on the domestic sectors also seem not to have been fully appreciated at the time. Were it not for a rigid system of price control, the price effect of foreign exchange restrictions would have been much more substantial than it presently is.

The economics of the situation is clear; the pressure of excess demand for imported commodities, consequent on import restriction is attempting to push all prices upward in spite of subsidies and price control. Already a buoyant secondary market in high demand essentials such as toilet soap exists side by side with the controlled market. Demand, restrained with respect to imports, has spilled over into domestically produced goods which are substitutes for controlled imports. In some cases, e.g. in the production of agriculture commodities, the market has been able to respond to this stimulus with increased levels of production. However, in the manufacturing sector it has not been possible to expand the level of production - mainly because of its high import content.

There seems little doubt that as a result of the quota allocations of the Budget, production, especially in the smaller import-dependent manufacturing industries, has been reduced. The degree of reduction is difficult to quantify, nevertheless our conclusion is based on first-hand reports from the businessmen themselves. In a period when maximization of export earnings should be of paramount concern, a Foreign Exchange Budget should not prove most burdensome to those who have a vital contribution to make to the economy.

With respect to the issue of whether the Foreign Exchange Budget has led to some increase in the level of unemployment, a priori one would expect some dislocations to occur if production levels are not uniformly being maintained. There have been to date few instances of retrenchment. In the private sector, businessmen have attempted to maintain the level of staff by temporary reorganizations of their firms. In the public sector an attempt has been made to maintain employment levels by redeploying persons previously employed on projects to fill existing vacancies in other parts of the public sector. However, many persons not on the fixed establishment have found themselves numbered among the unemployed. Further, falling production and exports in the small manufacturing sector gives rise to much concern as to the potential effect on future employment levels.

The effect of the Budget on industrial strategy cannot yet be evaluated, however, it is clear that uncertainty as to the level of quotas for 1978 can have a serious effect on the ability of companies to plan their activity for the future.

One major unfortunate effect of the Budget, has been that for the population as a whole, it has come to be associated only with its negative aspects such as occasional shortages, and black-marketing. Such responses will need to be corrected if public support for the Budget is to be enlisted. Continuing the exercise when the present economic situation improves to one of less austerity may assist in reversing present attitudes. Integrating it as a fundamental aspect of national economic planning will accelerate the normalization process even further.

CONCLUSION:

Our short experience with Foreign Exchange Budgeting in Guyana, if it has taught us nothing else, has taught that the exercise cannot be viewed only as a tool for Balance of Payments correction. The more preoccupied we are with this objective, the less beneficial will be the overall effect of the Budget. Other variables crucial to the explanation of our present position need also to be controlled. One that comes to mind immediately is the rate of bank credit extended to the Central Government, which in Guyana expanded by around 250% in 1976. It is unsound economics that direct controls on imports should be in force, while public sector credit continues to expand at unacceptable rates.

Another lesson which we have learnt is that the Foreign Exchange Budget, and therefore the National Development Plans cannot divorce themselves from issues of reserve adequacy and reserve management. Previously, we have been content only to monitor reserve movements. If, however, the Budgeting exercise is to assist in the development of our countries, one important task which it would have to undertake would be to ensure that adequate foreign exchange is available for priority areas, with a cushion left over to smooth out the effects of unexpected shortfalls in foreign exchange receipts.

The task ahead of us is to evaluate our short experience with Foreign Exchange Budgeting carefully and to ensure that the lessons which it has so far taught us are not lost in the process of policy-formulation.

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