Advance Deposit Requirements for Imports

Eugene A. Birnbaum and Moeen A. Qureshi*

THE USE of advance import deposits as a means of implementing economic policy has spread rapidly in recent years. Most frequently used in Latin America, this technique has been applied in more than 20 countries in various parts of the world.[1] The experience gained in recent years makes it possible now to analyze and to assess their functions as part of a general system of exchange and trade restrictions, and their contribution to the achievement of monetary stability.

The provisions governing advance deposit requirements vary widely from country to country. The deposits are usually required to be in local currency, though in some cases[2] dollar deposits are required, and in Chile dollar-denominated treasury debentures are admissible. Their amount is generally stipulated as a percentage of the value of imports. As a rule, an importer is required to make the deposit in a commercial bank which in turn usually must transfer it to a special account in the central bank. The deposit is held for a defined period of time, at the end of which it is returned to the importer. In general, the deposit is required when application is made for an import license or exchange permit, or within a specified period after the license has been granted. If there is no exchange licensing, the requirement to deposit may be linked to the opening of letters of credit, the shipment of goods from abroad, the arrival of the goods, or their clearance through customs. The timing of the return of the deposit to the importer also varies widely. It may be returned when

*Mr. Birnbaum, Loan Officer with the U.S. Development Loan Fund, is also a lecturer in International Economics at the George Washington University. He was formerly economist in the Finance Division, Research and Statistics Department, of the International Monetary Fund.

Mr. Qureshi, economist in the Exchange Restrictions Department, was educated at the University of the Punjab, Lahore, and Indiana University. He was formerly Deputy Chief in the Economic Division of the Pakistan Planning Commission.

[1] At the time of writing there were 16 countries using advance deposit requirements for imports: Bolivia, Chile, Colombia, Ecuador, Ethiopia, Greece, Iceland, Israel, Indonesia, Japan, Nicaragua, Paraguay, Peru, the Philippines, Turkey, and Uruguay. This list does not include countries like Brazil, where the technique of selling foreign exchange involves in effect an advance deposit in the form of a prepayment of part of the local currency spent on foreign exchange. Countries which have tried advance deposit systems but subsequently abolished them include Argentina, Denmark, Finland, France, the Federal Republic of Germany, and Spain.

[2] Ecuador and Bolivia.

action has been taken on his application for an import license (Japan); when the goods are imported, i.e., cleared through customs (Spain); when the foreign exchange payment is finally made (Turkey); after a specified period from the date on which the deposit was made (Paraguay); or after a specified period from the date of clearance through customs. Thus, the retention period during which funds remain deposited may vary from a few days to many months.

The amount of the advance deposit varies from a small percentage to several times the value of the import. In Ecuador, for example, where the regulation applies to specified imports, the requirement ranges from 25 per cent to 100 per cent of the import value. In Chile, the range is from 5 per cent to 5,000 per cent, depending upon the "essentiality" of the imported goods. Because of the wide range in the amount and the period of retention of the required deposits and the varying importance of imports in the economies concerned, the amount of funds held at any one time in the form of advance deposits also varies widely from country to country. In Paraguay, these funds were at one time equal to almost one third of the money supply.

Advance deposit systems vary widely with regard to their differentiation between commodities. As one extreme example, Bolivia applies advance deposit requirements only to imports of automobiles. Colombia applies them to almost all imports. While differential treatment is usually related to the "essentiality" of the commodity, some regulations vary the requirements according to the type or method of payment involved. In Greece, for example, the advance deposit requirement for goods imported on the basis of cash against shipping documents is 50 per cent to 100 per cent. For imports against a time draft, a bank guarantee of 25 per cent of the import value (c.i.f.) is required, but shipments payable by letter of credit require no advance deposit or bank guarantee.

However the advance deposit technique may differ from country to country, its original purpose has normally been to discourage imports by increasing their cost as importers are forced to obtain additional financing to make the deposit. But the system also has the effect of temporarily absorbing liquidity, and, as the result of experience, this may come to be regarded as an important purpose. Thus, while advance deposits are used primarily to limit international payments, they also serve as an instrument of domestic monetary policy.

Two questions arise in regard to the use of advance import deposits as an instrument of monetary policy: (1) To what extent will the banks satisfy the additional credit demand that the deposit requirement generates? In some countries, e.g., Indonesia, an attempt is made to avoid bank financing of advance deposits by prohibiting such financing either wholly or partially. (2) What shall be done with the accumulating deposits? A government in need of revenue may, for instance, want to use the deposits to finance its budget. It can do this by borrowing them from their depositary (Indonesia) or directly by permitting importers to meet the requirement by purchasing government bonds instead of depositing cash. In Chile, for example, importers are permitted to purchase dollar-denominated short-term government obligations in lieu of making cash advance deposits. Advance deposits may thus be used as an instrument of government finance.

In addition to economic reasons, there may be procedural or tactical reasons for the introduction of advance deposits. Their introduction and implementation may appear to be technically easier than alternative measures that would have approximately the same effects. Tariff changes may involve undue delay if they require legislative action or the approval of the CONTRACTING PARTIES to the General Agreement on Tariffs and Trade; changes in multiple rates require Fund approval. An advance deposit requirement, on the other hand, is often considered to be within the administrative powers of the central bank. There may be less public resistance to a measure such as an advance deposit requirement, which is ostensibly directed at a particular economic sector, than to an increase in bank reserve requirements against deposits, which more overtly affects all borrowers.

The direct effects on imports of advance deposits are discussed in the next section, and the less direct effects that derive from the monetary impact of these deposits on the economy at large, in a later section of this paper.

Advance Deposits as a Device to Restrain Imports

The direct effects of an advance deposit requirement on the demand for imports depend on the availability of funds to finance the deposit and, if funds are available, on the cost to importers of this additional financing. When the importer finances the deposit from his own resources, the cost involved is the opportunity cost of using the money in his own business. In an inflationary situation, this opportunity cost will include allowance for the expected drop in the purchasing power of the local currency. If the funds required to make the advance deposit are borrowed, the importer has to pay bank charges, in the form of interest and commissions. Rates charged by banks often do not fully reflect the declining value of the currency. Even then, the cost to the importer of tying up borrowed money in advance deposits in local currency may be as high as if he had used his own money, for, in the absence of the advance deposit requirement, he might have borrowed the same amount of money and employed it in his business. In those cases where advance deposits in dollars are permitted, the importer stands to share in the consequences of any rise in their value in terms of local currency.

The interest cost of the additional financing required to make the advance deposit adds a varying amount to the cost of importing, depending upon the size of the advance deposit, the length of time it is retained, and the cost of borrowing.

In the absence of inflation, this cost may be moderate. Given an interest rate even as high as 15 per cent, an advance deposit requirement of 100 per cent of the value of imports, and a retention period of three months, the additional interest cost resulting from advance deposit payments would be only about 4 per cent of the total import cost. This appears to be a reasonable estimate of the interest costs involved in about half of the countries with advance deposit requirements, though in some of the other countries the interest costs may well be substantially higher.

In inflationary conditions, the cost is increased in the manner described above. Moreover, when advance deposits are as high as 300 per cent of the import value, as in Paraguay for certain imports, the additional interest cost has a more restrictive effect on import demand; and when advance deposits reach 5,000 per cent—as in Chile for one category of luxury goods—the cost may well be prohibitive.

The extent of the restrictive effect on imports of an advance deposit requirement clearly depends on the relative profitability of importing as an enterprise, and this varies with the environment in which the importers operate. An increase in working capital requirements with its implicit or explicit interest costs may, in an environment with attractive alternative investment possibilities, effectively discourage imports and transfer resources from the import sector to other productive activities and may reduce imports by significant amounts. A potential increase in the cost of imports might help to curb any speculative tendency on the part of importers to overestimate their requirements. In many of the countries which have adopted advance deposit requirements, however, the threat of inflation makes investment in inventories of imported goods particularly attractive. Moreover, doubts about the future availability of imports, aroused in part by the imposition of the advance deposit requirements themselves, may help to increase the expectation of high profits more than enough to offset the restrictive effects of the higher cost associated with advance deposit requirements.

The difficulty of obtaining the additional finance necessary to make advance deposits will, of course, tend to be reflected in the interest charges. In certain countries, bank financing of advance deposits is wholly or partially prohibited. Even when bank financing is permitted, however, the imperfections of the money market in underdeveloped countries and the varying degrees of creditworthiness of individual importers may make it difficult to obtain the necessary finance, particularly if deposit requirements are high.[3] However, experience in most countries where advance deposits have been required indicates that, except where the advance deposit system is accompanied by a generally tight monetary policy, the difficulty of obtaining the additional financing is seldom by itself a serious obstacle to importation because of the preferred status of imports as a basis for credit.[4] Even when bank financing of advance deposits is prohibited, alternative sources of finance can usually be found, although in such cases the interest cost of the additional funds may be somewhat higher.

There are three principal reasons for the relative ease with which it is normally possible to find financing. First, loans for import advance deposits are virtually riskless: the deposits, even if not actually held in the lending bank itself, fully guarantee the loan. Second, in the countries where the advance deposit device is used, it is likely that the financing of imports and importers' inventories forms a large part of commercial bank business. The financing instruments are considered to be prime commercial paper, and importers occupy a preferred position among the banks' customers. Third, foreign exporters, anxious to maintain their markets, tend to make available to importers more generous suppliers' credit, financed in larger foreign money markets under conditions more favorable than those in the money markets of the importers' countries.

Apart from serving as a general device to restrict imports, advance deposit requirements have also been used in some countries to influence the type of commodity imported or the country of origin. The technique that has been adopted most often to influence commodity composition is to distinguish between essentials, nonessentials, and luxuries and to apply an increasing scale of requirements. In Chile, the range of advance deposit requirements, from 5 per cent to 5,000 per cent of the c.i.f. value of imports, covers ten different categories; the period for which the advance deposit is retained varies from 30 to 90 days, depending again upon the essentiality of the import. Similarly, the deposit requirements

[3] It has been observed that this may tend to "... stifle the development of smaller firms and thereby contribute to the growth of monopoly." See *Memoria, V Reunión de Técnicos de los Bancos Centrales del Continente Americano* (Bogotá, 1957), Tomo III, p. 13.

[4] Referring to the experience of the Federal Republic of Germany in the early 1950's, Professor Otto Veit found "... that the banks gladly undertook to finance the provision of these monies, because for them this was a transaction completely free from risk. ..." See *Changes in Monetary Policy and Their Consequences* (Prof. Dr. Otto Veit with the assistance of others, Institute for Credit Study, Johann Wolfgang Goethe-University, Frankfurt am Main, Germany, 1957), pp. 136–37.

may vary according to the country of origin of imports, e.g., imports from neighboring countries may be exempt. Illustrations of this kind of differentiation may be found in the arrangements recently eliminated in Argentina and in the practices of Paraguay and Ecuador.

In practice, advance deposit requirements do not appear to have had a very substantial effect on the direction of trade. Either more basic factors—such as quality and supply conditions—dominate, or discrimination by preferential treatment in advance deposit arrangements plays a supporting role to more direct discrimination through bilateral agreements. In a situation of tight credit, however, exemption of imports from neighboring countries has not been without effect. A similar conclusion seems warranted with regard to the commodity composition of imports. The relatively small differences in cost are generally not enough to shift any marked amount of import demand from one commodity category to another. However, in cases such as Chile, where the requirements are tantamount to prohibition of the import of "luxuries," some impact on composition is inevitable.

Some of the characteristics of advance deposit requirements can be indicated by comparing them with other measures designed to restrict imports.

(1) While tariffs, multiple rates, or import surcharges could have equivalent effects in reducing imports and also produce revenue for the government, advance deposits cannot produce revenue. Instead, their proceeds create a liability of the central bank or the government to the private sector, with an attendant inflationary impact when this liability is discharged.

(2) Advance import deposits tend, in the circumstances of the less developed countries where they are principally found, to have an arbitrary (or at least an uneven) impact. To importers with longer-established businesses, to importers with the better connections with foreign suppliers, and to importers with greater financial strength of their own, the cost of financing the additional working capital is likely to be lower than it is for their less favored competitors. Thus advance deposits may discriminate more, and more directly, between importers than do the more impartial import-restricting devices which operate through the modification of prices.

(3) When, as has often occurred, advance deposit requirements have been added to import-restrictive devices already in existence, such as quantitative restrictions, multiple rates, and import and exchange taxes, they have served further to complicate the exchange system.

Another characteristic of the advance deposit technique is that, as monetary policy may be made more or less severe and interest rates within the economy change, the restrictive effect upon imports of advance deposits also varies.

Advance Deposits as an Instrument of Monetary Policy

Importers may be required to lodge advance deposits either with the central bank or with a commercial bank; in the latter case, the bank may or may not be required to redeposit the amounts with the central bank. Importers may use currency or bank deposits, either drawn from their own cash balances or from another's, or obtained from bank loans negotiated for the purpose. In all cases, monetary claims on the banking system are transformed into nonmonetary (i.e., less liquid) claims. In exchange for the deposits, importers receive an obligation of the depositary (central bank or commercial bank) or of the government.

From the point of view of monetary policy, an advance deposit regulation is of importance in at least three respects: (1) the direct effect on current private sector expenditures; (2) the effect on the supply of loanable funds of the commercial banks; and (3) the uneven time distribution of both these effects.

Where no new bank credits are available to build up the advance deposits, the necessary funds will have to be found from the working capital of the private sector of the economy or financed through disinvestment, e.g., by a reduction in importers' inventories or in inventories generally. The accumulation of the advance deposits will then have, apart from their price effect, a contractive effect on income, as a result of which total demand, including that for imports, will fall.

The accumulation of advance deposits will, in general, also affect the liquidity position of the banks and thus possibly the volume of bank credit to the economy, and therefore the rate of expenditure. The magnitude of this effect depends on the initial position of the banks and on the nature of the credit controls in force, as well as on the terms of the advance deposit requirements.

If advance deposits were to be lodged solely with commercial banks, e.g., in a special account, and the reserve requirement of the banks did not apply to this special account, the banks could always lend to importers the amount needed to finance the advance deposits to be accumulated (unless there were rigid credit ceilings) by performing what in essence would be a mere bookkeeping operation: the depositary bank would simply debit its loan account with the importer and credit the special account. Moreover, such loans, being completely riskless and not impairing the banks' liquidity position, would be highly attractive to the banks. Such an arrangement would leave unchanged the economy's holdings of spendable funds, and the advance deposit accumulation would have no monetary effect.

However, the standard practice is to require the advance deposit to be lodged with the central bank—either directly by establishing a special account with the central bank, or indirectly by requiring the commercial banks to hold 100 per cent reserves against it. In either case, the liquidity of the banks suffers a reduction.

If initially the banks held excess reserves—i.e., more liquid assets than either the law or well-established custom requires—they could lend to importers the funds necessary to accumulate the advance deposits (at the expense, of course, of future loan expansion). The effect on current expenditures in this case would be negligible, if it can be assumed that the bank financing of the advance deposit does not create a shortage of funds that otherwise would have been used for other purposes.

If, however, the banks had no excess reserves, they would be unable to lend to importers the additional finance necessary for the advance deposits without calling in other loans. If, as is likely, the banks should regard advance deposit finance as more attractive than some of their outstanding loans, and should accordingly call in loans to the extent necessary to meet importers' requirements, there would tend to be a contraction of credit as the economy adjusted to a smaller reserve base. If importers turned for finance to nonbank sources instead of to the banks, the process of adjustment would, in the long run, bring virtually the same results that would have occurred had the importer been financed initially by the banks. In either case, the extent of the credit contraction would depend upon the magnitude of the money multiplier, and the strength of the determination of the banking system and the private sector to maintain the *status quo ante* liquidity position.

If new money is simultaneously being put into circulation through government deficits financed by borrowing from the central bank, or by an inflow of gold, or the like, the process of contraction may, of course, be neutralized. This would tend to be the case where the importer is permitted to buy government bonds as an alternative to lodging cash deposits with the bank, and the government then spends the funds so obtained.

Thus, if the accumulation of advance deposits is to have a monetary effect, at least two conditions must be satisfied: (1) advance deposits must be sterilized with the central bank; (2) credit controls must be sufficiently tight to prevent either direct or indirect bank financing of the deposits. This latter condition may be met in the form of over-all ceilings on bank credit, or through sufficiently high reserve requirements and rigorous limits on central bank accommodation to the deposit banks. In view of the central bank practice of providing rediscount and loan accommodation on liberal terms to the commercial banks, which is frequently found in countries using the advance deposit technique, this point deserves special emphasis.

Finally, it is important to note that any restrictive monetary effect is temporary: it operates only for the period during which the advance deposits are actually being accumulated with depositaries and frozen there. With a given flow of imports, this accumulation will continue from the time the advance deposit scheme is put into effect and for the period for which each deposit is to be held. After that, there will be no further net contraction.

When an advance deposit requirement is removed, there will—again for a period (equal to the time the requirement effectively forces the lodgment of the advance deposit in their depositary)—be a net monetary expansion. A similar threat of increased liquidity in the economy occurs if imports decline while the advance deposit system is in effect. Unless at the time of their release other measures are taken to maintain the monetary sterilization of the accumulated advance deposits, the economy will be threatened by an inflationary expansion.

Conclusion

The existence of institutional limitations may, at times, have prevented or checked the use of other instruments of monetary policy, and so have led to the adoption of the advance deposit technique for meeting temporary needs. This may have been an important consideration in Uruguay, for example, where changes in bank reserve requirements require legislative approval which may be difficult to obtain with sufficient promptness. In some countries, open market operations are ruled out as an alternative because of the absence of a developed money market.

The advance deposit technique has been used as a support for stabilization programs which involve a major relaxation of trade and exchange restrictions. The application of advance deposits in Spain, for example, might have been designed to absorb liquid funds held outside the banking system which could not effectively be reached by the traditional instruments of monetary policy; it might also have been used to discourage speculative imports considered as likely to follow the introduction of import liberalization. The fact that the first effects of advance deposits upon the demand for imports are likely to be felt quickly may add to their attractiveness.

While, in general, advance deposits have been regarded as an instrument that would help to restore equilibrium, in practice they have often tended to produce the opposite result. The immediate effect of the payment of an advance deposit is to reduce the liquidity of the economy, but the effect of its subsequent repayment cannot easily be controlled. If, for example, the authorities feel obliged to reinforce the import-reducing effects of advance deposit requirements by resort to more direct measures, such as new or more stringent quantitative import restrictions, the decline in imports that then occurs will be accompanied by a release of advance deposits which serves to generate additional inflationary pressure. Advance deposits may similarly be released if advance deposit requirements already imposed are made more stringent, depending upon the import elasticity of demand.

The intended stabilization effect of advance deposits sometimes has not been realized because the government has not been able to resist the temptation to use the accumulation of such deposits, which ought to be sterilized with the central bank, for financing the fiscal deficit. In other situations, the accumulated advance deposits, although not used directly for budget purposes, indirectly provide a basis for relaxing needed financial restraints. In such circumstances, government expenditure may tend to rise and new inflationary forces be set in motion. In some countries, advance deposits are financed by an expansion of commercial bank credit, which is supported in turn by the continuous creation of central bank monetary liabilities to finance persistent fiscal deficits: under these circumstances, the accumulation of advance deposits with the central bank makes no significant contribution as an instrument of anti-inflationary policy.

Advance deposits are usually regarded as a temporary device, the use of which will in due course be brought to an end. The decision to terminate an advance deposit system, however, presents in an acute form the problem of the timing of the effects of their repayment upon liquidity, for liquidity will be expanded unless at the same time other measures are taken to ensure that the effects of the sterilization of advance deposits should not be relaxed. It is obvious that the task of abolishing an advance deposit system becomes increasingly difficult if the accumulation of deposits has been allowed to grow to unwieldy proportions.

On the assumption that a decision has been made to terminate an advance deposit system, the most appropriate method would be a program spaced over a number of months, accompanied by fiscal and credit control measures to generate effective offsetting deflationary forces with approximately equivalent timing. The choice of these measures would necessarily be influenced by the degree of inflation in the economy, by the liquidity position both inside and outside the banking system, and by the size of the accumulated deposits in relation to national income and money supply. In some circumstances, the temporary use of bank credit ceilings or other direct controls may be suitable. In others, the most effective course might be the enforcement of a system of new or higher average reserve requirements against deposit liabilities of commercial banks.

Since an abrupt uniform increase in average reserve requirements might work undue hardship upon certain banks in countries where bank liquidity is unevenly distributed, it might be considered better, as a transitional measure, to introduce a device such as a 100 per cent marginal reserve requirement. By this means, that part of the released advance deposits that was used by importers to increase their demand deposit balances would be sterilized. However, to the extent that advance deposits had been financed by commercial bank loans, the released deposits would be available to repay these loans; this would provide the commercial banks with a fresh supply of loanable funds, since there would be no increase in their demand deposit liabilities and therefore no corresponding increase in required marginal reserves. These reserves could not be used to sustain a multiple expansion of credit, however, so long as the 100 per cent marginal reserve requirement remained in force.

All these considerations and the experience of many countries indicate that the merits of advance deposit devices are strictly limited. Imports can usually be restricted and monetary policy influenced more effectively by other measures. Moreover, advance deposit requirements tend to have undesirable side effects. Although under certain special conditions an advance deposit scheme may serve a transitory need, the use of this instrument of policy appears to be generally inadvisable.[5]

[5] For an earlier study, see Jorge Marshall, "Advance Deposits on Imports," *Staff Papers*, Vol. VI (1957–58), pp. 239–57.