RECENT ECONOMIC POLICY IN BARBADOS 1970-84

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Introduction

The economic policies of developing countries are often criticized. Overvalued exchange rates, incorrect pricing strategies, excessive money creation and over-involvement of government in economic activity are but some of the views put forward in academic and professional circles. Since the early 1970s discussion on these issues has become more intense as many developing countries have suffered from the instability of the international economic system. Stagflation, shorter business cycles, unusally high interest rates, substantial exchange rate variation, adverse terms of trade movements and massive debt accumulation represent some of the difficulties which these countries have faced. Their response has been affected by their economic conditions and by their political objectives. Their success has been mixed and for many it has meant the bitter pill of the International Monetary Fund (IMF's) prescriptions.

For Barbados, size and openness are perhaps the most critical influences on economic performance and policy. External developments have been the major determinants of economic activity and prices, often containing or stimulating the pace of economic growth. Although the authorities chief aim has been economic growth, this objective was often secondary to the need to protect the balance of payments. It is our contention that in

times of crisis monetary policy was successful in reducing balance of payments difficulties. Fiscal Policy, though supportive of the balance of payments needs, was more successful when encouraging expansionary policies.

The general approach to policy making was through fiscal and monetary policies. Exchange rate management, prices and incomes policies played a more passive role. In this paper, we examine the fiscal and monetary policy measures initiated, their timing and their effectiveness. In later work we plan to look at the reasons why other policies did not play an active role in macroeconomic adjustment. Several questions emerge as to the suitability of low interest rates, fixed exchange rates and selective credit controls on the monetary side while the expansionary role of government, its impact on the private sector and policy shifts between direct and indirect taxation from the core of analysis on fiscal policy.

1. Economic Performance 1970-84

Living standards in Barbados improved during the period 1970-84. Notwithstanding the recessions of 1973-75 and 1981-83, income grew by almost one percent per annum. Both recessions were marked by increasingly high levels of unemployment and by 1984, the number of unemployed had more than doubled. Inflation, so modest in the preceding decade, accelerated under the influence of external pressures in the mid 70s, but by 1984 it had eased to single digits as inflation abroad abated. Unstable

export demand and prices coupled with rising import prices made the balance of payments erratic.

The Barbadian public entered the 1970s with great expectations. The 1960s had been a period of exceptional growth and relatively low inflation. The international economy was experiencing a low inflation boom under the Bretton Woods fixed exchange rate system and as a result Barbados benefitted from substantial foreign investment in its private sector. The manufacturing and tourism sectors responded to government's fiscal incentives schemes and even though there was some contraction of the manufacturing sector between 1967-69 the economy appeared to have gained the resilience which had been lacking in the past.

The first half of the new decade showed that this optimism was exaggerated spiralling import prices and fluctuating commodity prices underlined the vulnerability of open economies, however diversified. Internal and external balance were adversely affected (Chart 1), and for the first time the fiscal position reached worrying proportions. The recovery of the international economy led to renewed economic growth in the late 1970s but the second oil shock of 1979 and the attendant adjustment measures to curb inflation in industrial countries put the brakes on economic expansion and created balance of payments difficulties.

Throughout the period, the economy was driven by the export sectors of sugar, manufacturing and tourism. However, the sugar industry which had begun to lose ground by 1970, faltered further under the pressure of unrenumerative prices. The manufacturing sector, encouraged by the potential of the regional export market, grew rapidly but once this outlet was virtually shut off in the 1980s the industry tottered, incurring substantial job losses in the process. The tourism industry rose and fell with the business cycle but excess capacity kept the industry's financial viability below what might be expected.

The uncertain economic environment made the balance of payments a more important indicator during this period than it had been during the 1960s. There were at least six balance of payments deficits of varying magnitudes and with reserve levels well below historic levels[1] there was considerable borrowing -long and short term - for balance of payments support. Import demand reacted sluggishly to contracting income and in the light of unpredictable export earnings stringent measures had to be taken to keep the current account deficit to GDP ratio within acceptable limits (Chart 2). By 1984, the weakness of the economy had forced such adjustment that a small surplus on the current account, the first on record, was achieved.

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1. Between 1963-69 the import cover ratio ranged from four months to eight months. The large holdings were mainly due to the institutional arrangements governing the operations of the existing monetary authorities.

The pattern of relatively stable prices quickly faded in the setting of the 1970s. The oil price shock affected all countries, not least Barbados. Prices soared and the situation was made worse by the simultaneous implementation of the Common External Tariff (CET) as part of the Caricom agreement. Inflation subsequently slowed, but rising prices abroad kept inflation in double digits during the 1970s and early 1980s. The success of the US and Eurpean economies in curbing inflation after 1981 brought domestic inflation to less than five percent in 1984.

For purposes of analysis, the economic performance of 1970-84 can be divided into four phases:

(1) origins of crisis 1970-73;
(2) crisis 1974-76
(3) economic expansion 1977-80
(4) crisis revisited 1981-84

Origins of Crisis 1970-73

This phase marked the beginning of current economic difficulties. In 1970, the goals of economic policy were to maintain the economic growth of the 1960s, reduce unemployment further, contain inflation to current levels of eight percent or less and restore a sound balance of payments position. By the end of 1973, none of these objectives had been achieved. Even though the manufacturing sector experienced renewed growth after the contraction of the late 1960s, the economy grew slowly as

sugar production trended downwards and tourism began to stabilize around two percent per annum. This slowdown kept the current account deficit in excess of 20% of GDP and except for 1971, a year of slow import growth, reserves were run down every year from 1969-73.

In 1973, the growing economic difficulties were magnified by the fourfold increase in the price of oil. The full impact of this development was not felt since the higher prices only came about in the second half of the year. Yet, oil imports were three times higher than the year before, the cost of all other imports rose and domestic inflation, already in double digits before the oil price hike, accelerated. By year-end prices were 26% higher than they were the preceding December. Uncertainty reigned and the prospects for economic activity in 1974 looked dim.

Crisis 1974-76

The ominous signs on the horizon turned to crisis in 1974-75 as prices rose quickly, economic activity declined and unemployment accelerated. However, there was a little improvement in the balance of payments resulting from windfall gains from high sugar export prices. This turn of events was fuelled by external circumstances, but there were other critical factors. We have already mentioned the CET which together with a deflationary sales tax in late 1974 kept prices rising above what might normally be expected. In addition, a 37.5% decline in

sugar production between 1970-75 reduced output and potential earnings at a time when sugar prices were high.

The steep rise in prices raised expectations of inflation. Nominal wage settlements were higher than usual but on average consumer's purchasing power was eroded. In addition, with the international economic conditions causing a slump in tourism, activity in the distributive sector slowed and unemployment worsened. Economic policies, fiscal and monetary, sought to discourage expenditure, particularly on imported goods. The impact of these measures together with unexplained capital flows prevented a further deterioration of the balance of payments in 1974. However, in 1975 lower import volumes, attendant on the weakness of the economy, and the improved terms of trade (Chart 2) facilitated a substantial reserve increase.

The economy began to emerge from economic decline in 1976, but the balance of payments remained an issue of major concern. Government's vigorous price control policy together with the passing of the price shocks of 1973-74 permitted a moderation of inflation to single digits. Economic activity, spurred on by increased production in the manufacturing sector, rose sharply even though remaining below 1973 levels. However, government's fiscal policy was more expansionary than in former years and with an ease of import controls in the second half of 1976, the reserve gains achieved in 1975 were completely eroded.

Economic Expansion 1977-80

The Barbados economy performed remarkably in the years 1977-80. Having failed to achieve its macro-objectives between 1970-76 because of the unstable economic environment, the economy benefitted now from improved economic conditions. Led by the tourism and manufacturing sectors, economic growth rates ranged between 3.6% - 7.9% for the period 1976-80 and unemployment reached its lowest level for almost a decade. With wages rising in excess of inflation in 1976-78 and again in 1980 and with the tax system adjusting to raise disposable incomes, much of the purchasing power lost in early years was regained. Inflation reached double digits again but this reflected simply the trend in the international economy.

With the strengthening of the economy, the balance of payments position improved considerably. The increase in economic activity and income kept import growth above that of exports, but the strong growth of tourist receipts contained the size of current account deficits. There was a trend towards larger fiscal deficits, but the balance of payments implications of this situation was reduced as substantial capital inflows were made available to finance government's programmes. Indeed, as the private sector began to repay debts incurred in earlier years, the public sector became the major beneficiary of long term capital inflows. With rising export earnings and modest debt service obligations from the 1960s and early 1970s, the public sector debt service was not unduly burdensome (Chart 3).

Crisis Revisited 1981-84

After the growth of the second half of the previous decade, the economy turned around abruptly in 1981. Output was depressed, job losses spiralled and the balance of payments was under constant pressure. The downturn was perhaps less chaotic than in 1974-75 as inflation did not add to the instability. However, whereas the economy was able to recover almost immediately from the earlier recession, now there was a deepening of the crisis. As with the earlier phases, the cause of the recession was largely external in origin, with the four major factors being:

(1) the systematic deflation of industrial countries economies to curb their inflation;

(2) the rise of protectionism regionally and extra-regionally;

(3) the inability to collect debt owed under the Caricom Multilateral Clearing Facility (CMCF);

(4) the parallel appreciation of the BDS$ with the US dollar against major currencies.

The manufacturing and tourism sectors suffered especially from the deflationary policies. High unemployment levels in North America and Europe meant fewer tourists, and except for the fast growing electronics sector, demand for manufactured goods declined. The Caricom market which had buoyed the industrial

sector since 1976 collapsed with the demise of the CMCF and the imposition of protectionist measures by some partner countries. In addition, after 1983, the swift fall in value of the Jamaican currency made Barbados' exports to that country uncompetitive in price. Sugar also declined further, first through abysmal weather conditions and later through unrenumerative prices as the appreciation of BDS$ currency against sterling reduced the potential earnings from the major guaranteed market - the European Economic Community.

It was only natural that depressed output should affect the balance of payments. The process of adjustment is generally slow and there was a record balance of payments deficit in 1981. The problem was compounded by the growing realization that more than half of the foreign reserves had become illiquid due to the inability of Guyana and Jamaica to settle its CMCF debts. Borrowings from the International Monetary Fund supported the balance of payments in 1982 and 1983, but the collapse of the CMCF arrangement in early 1983 was a harsh blow for a country in the throes of recession. By 1984 the tourism sector began to grow again and with import growth slowing considerably the economy had its first current account surplus on record. The surplus itself is a sign of the underlying weakness of the balance of payments position since a substantial part of import contraction was due to falling intermediate goods used in export sectors.

11. Economic Policy

The sway of the economy with movements in the industrial countries made the period 1970-84 especially challenging for policy-makers. As a result, except for the period 1976-80, the focus of policy moved away from expansionism towards economic adjustment. Even during that period, the desire to reduce external imbalance led to tight monetary policies. The shift of emphasis apart, the major features of economic management after 1970 were:

(i) the establishment of the Central Bank of Barbados[1] to foster economic growth;

(ii) the realignment of the exchange rate away from the pound sterling towards the US dollar;

(iii) the short-lived experiment to fight inflation through a vigorous policy of selective price controls.

Of these, the setting up of the Bank was perhaps the most significant. Prior to 1972, the East Caribbean Currency Authority, a regional institution served as the chief monetary authority, but its limited functions made it difficult for

1. Hereinafter referred to as the Bank.

government to control the commercial banking system. The Bank's capacity to carry out its mandate to implement the "monetary and financial policies required to promote the optimal rate of economic development" was immediately tested. Its role in the system became crucial since

(i) it had to ensure that the banking system was sufficiently liquid to perform its function;

(ii) it had to encourage credit allocation policies which might increase society's welfare;

(iii) it had to ensure that government did not misuse its new freedom to spend, resulting from the fact that it could be easily accommodated by the Bank;

(iv) it had to be careful that reserves were not run down at a rate which would impair its capacity to maintain the exchange rate and stability of the system.

The presence of fiscal and monetary agents meant that some degree of policy coordination was required to satisfy the desired objectives. Monetary policy often acted as a buffer to expansionist fiscal policy as it attempted to sterilize increases in disposable incomes through credit controls. However, it must be stressed that the powerful influence which the external environment exercises over small economies like Barbados' suggests that policy coordination though necessary is not a sufficient condition to ensure the achievement of targets.

1. Monetary Policy

The range of policy instruments in developing countries is smaller than in more developed countries. The Bank's primary tools in the process of adjustment were interest rates, selective credit controls and cash reserve and security requirements. These instruments, aimed at the economic growth and the balance of payments, were generally more successful with the latter, especially during periods of contraction. Stimulating the economy through monetary policy was much more difficult.

(a) Interest Rate Policy

The Bank's policy, consistent with that of many developing countries, was supportive of a stable low interest rate regime. Critics of this approach argue that low interest rates retard savings, investment and growth, noting that

(i) interest is a reward for accumulating financial assets and it influences the willingness to save out of current income;

(ii) capital is scarce in developing countries like Barbados and that the interest rate, the rental price of capital, should reflect this scarcity;

(iii) real interest rates should be positive since the marginal product of capital has to remain positive in a growing economy;

(iv) low interest rates may lead to a distortion of the credit allocation mechanism.

The Bank, however, did not seek to promote a policy of positive real interest rates. It countered that

(i) in the presence of effective exchange control measures and in the absence of alternative financial assets low deposit rates do not impede deposit growth. It was accepted, however, that any possibility of capital flight when overseas rates rise could be forestalled by keeping the differential between domestic and foreign rates small.

ii) high interest rates might deter potential investors, particularly small borrowers, whose enterprises have small equity bases. As a result, rates should be kept low through regulation;

iii) credit control measures should be used to address the problem of resource misallocation.

Prior to the Bank's establishment, the only regulation on general interest rates was a statutory limit of 8% on savings deposits. During this period rates moved in line with the London Bank Rates and this limit did not act as a constraint on deposit rates. Commercial banks paid little attention to real interest rates, lowering the prime rate in 1972, even as inflation was gathering momentum. Deposit growth and credit growth were strong

with the latter eventually putting pressure on the banking system's liquidity when deposit growth slowed in 1973.

The growing illiquidity of the system became apparent by mid 1973 as deposit rates reached their maximum. Deposit growth (4% in the twelve months to September) slowed as widening differentials between local and foreign rates and an anticipation of exchange controls encouraged an outflow of foreign currency. Loan demand remained strong and was partly financed by overseas borrowing at high rates. To ease the liquidity problem and to protect its reserve positon, the Bank --

i) raised interest rate ceilings to 10%

ii) designated the sterling area as foreign and thus made it more accessible to exchange control

iii) gradually imposed reserve requirements

iv) discouraged Eurodollar borrowing to finance domestic operations

v) discouraged consumer loans for imported durables

The first two measures together with the sharp downturn in loan demand stimulated some deposit growth but with the economy contracting and inflation spiralling there was no increase in real terms. Loan rates also rose, with the prime at December 1974 four percentage points above what it had been two years earlier. The Bank did not move actively to control loan rates but in its 1974 Annual Report argues that it persuaded Banks to exercise restraint in the setting of rates. Conscious of the

need to promote growth, the Bank introduced special financing schemes for the productive sectors at special rates.

With the economy in the doldrums, liquidity on the rise and credit hardly growing, the Bank, through its bank rate (down three percentage points) and by moral suasion attempted to pull interest rates down in 1975. In addition, the treasury bill rate was forced down to 4.0%, making lending to the private sector more attractive than lending to the government. Although there was a simultaneous increase in the banks' local assets ratios the excess liquidity to deposit ratio more than doubled. Deposit rates fell more quickly than loan rates, perhaps reflecting the commercial banks efforts to recoup losses attributable to holding idle funds or low earning assets. Dissatisfied with the rate of decline, the Bank not only lowered its bank rate and special discount rates in 1976, but set prime and average lending rates. With no flooring on deposit rates and liquidity high the return on savings deposits fell to 2.5%. As a result, the Bank, in August 1978, intervened for the only time between 1976-80, setting a minimum deposit rate of 3%. This however, had no effect on the general strucutre of interest rates.

After the stability of the previous four years, interest rate policy was extremely active after 1980. The rising tide of recession abroad, a widening differential between foreign and domestic interest rates and a sharp increase in domestic incomes induced the Bank to alter its interest rate policy. Balance of payments considerations were the prime motivating influence on

tlstance as the Bank sought to encourage savings and
djed spending. As it became clear that foreign firms were
ur to keep funds idle in Barbados when a much higher
res available abroad, interest rates were raised in an
ej reduce the differential between domestic and foreign
rthis target was made difficult by the continuous increase
irn rates. Between May 1980 and October 1981, regulated
sand lending rates increased by five percentage points.
D:ials which had ranged between 12 - 14 percentage points
i:rst quarter of 1980 fell to 4 - 5 percentage points.
Tlrate which stood at 6.0% between 1976-79 was raised to
2:81 to discourage credit expansion, but this penal rate
d:ppear to have the deterrent effect intended.

s institutional rates trended downwards and as the
ales tried to stimulate the economy there was a
pt decline in interest rates after 1982. However, the
e:f the recession on the domestic economy were prolonged
aldemand remained weak. Notwithstanding the fact that low
i) permitted substantially positive real rates, commercial
ble extremely cautious about new customers. Increasing
l(unemployment and a relatively tight credit policy
c(loan demand.

he response of the banking system and of the economy to
irate changes yields some interesting observations:

i) negative real rates are not necessarily an
impediment to real growth, savings or investment as

the period of strong growth 1976-80 indicates. Whether deposit or economic growth would have been stronger with positive real rates during this period is difficult to assess;

(ii) although it is tempting to attribute the period of strong growth to low interest rates, the strength of the international economy in providing the engine of growth cannot be discounted;

(iii) there is no clear indication of what the appropriate differential between domestic and foreign rates should be. Deposits grew in 1979 by 23.5% even though the differential was almost eight percentage points by year-end. In 1973, a much smaller differential led to a dramatic decline in deposit growth.

Credit Controls

From its inception, the Bank accepted that in a small open economy credit rather than the money supply is the appropriate variable of control. Priority was attached to selective credit controls in the exercise of monetary policy since banks displayed a willingness to lend to the trade sectors

at the expense of the new and growing industries. The long term objectives of credit policy were -

(i) to divert credit away from the import using personal and distributive sectors;

(ii) to channel more funds to the producing sectors.

These aims were conditioned by the nature of credit distribution in 1972, but as we shall see they dovetailed throughout the period with short term balance of payments policies. The Bank's ignoring the criticisms that such policies constitute an inflation tax on the non-preferred sectors and affect the process of financial intermediation [Johnson 1974] implemented its selective credit policy through

(i) a rediscount of commerical bank paper at low interest rates;

(ii) ceilings set in terms of fixed percentage growth rates.

There was virtually no success with its rediscount policy, as little use was made of the credits for manufacturing and tourism.

From a long term perspective, the Bank's ceilings did have some impact on the distribution of credit. Overall credit grew by 11.1% p.a. while credit to the producing, consuming and ancillary sectors grew by 11.5%, 8.4% and 15.7% respectively. The disparate growth rates of the various sectors is reflected in

the fact that the share of credit to the consumption sectors fell from 44.7% in 1972 to 33.3% in 1984 while the ancillary sector's share rose by ten percentage points to 29%. However, the sectoral share of the producing sectors barely rose from 36.3% to 37.7% during the same period partly because of the banking system's responsibility for financing the ailing sugar industry diminished. This factor together with the failure of the rediscount facilities to take off suggest that it is easier to prevent banks from following undesirable paths than it is to guide them along the desired path. Thus, it is perhaps more instructive to review the sucesss of the short term aspects of credit control policy.

In 1972, with the Bank still in its formative stages it attempted to persuade the banking system to alter its lending policies. Import demand was high and the balance of payments was weakening but the Bank, was cautious in its approach. It did forbid commercial banks to finance their domestic credit operations through foreign borrowing without reference to the Central Bank, but this apart it relied on a gradual phasing in of its reserve and security ratios as a deterrent to credit expansion. In 1974 and 1975 credit grew by only 3.9% and 7.9% even though inflation exceeded 20% in each year. It must be

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1. The producing sectors are broadly defined to include the export sectors, mining and construction. The consuming sector here refers to the personal and distribution sub-sectors only.

noted however, that credit to the personal sectors increased by 11.6% in 1974, 17.3% in 1975 and a further 18.5% between 1976. Initially there was some movement away from consumer durables towards home improvement, but economic growth and a freer import system in the latter half of 1976 induced a resurgence of imported consumer durables.

After 1976, selective credit controls became an active agent of policy. The sharp deterioration of the balance of payments in the latter part of 1976 induced the Bank to take direct stringent measures in an effort to redress the situation. Early in 1977, banks were ordered to reduce installment credit on selected categories by 25%. The Hire-purchase, Credit sale and Hire Control Act of 1975, by which minimum downpayments and maximum repayment periods of items sold under hire prchase contracts were specified, was employed and limits were placed on credit to the distribution and personal sectors. The measures were generally successful, and with reserves on the rise as the economy, led by its export sectors, expanded there was some ease in policy in 1978 and 1979.

By January 1980, notwithstanding the current strength of the economy, the Bank was concerned about the pace at which the economy as growing and of the effects the recessionary trends in the international economy might have on the economy. Accordingly, there was a tightening of credit to the distributon and personal sectors, including home improvement. The distributive sector, was allowed to increase its borrowings by

12½% while the personal sector was only permitted to grow by five percent. However, exemptions on mortgages and home improvements from the limits to personal lending allowed credit to grow by more than the stipulated level after 1981. As the exports sectors weakened through 1981-82, these measures were tightened and reinforced (See Saunders and Wood 1985). The tight conditions led to the emergence of new financial institutions, but these were quickly brought under the control of the Bank.

The general success in containing the expansion of credit helped the BOP in difficult conditions. Housing needs apart, credit for personal sector was less liberal than for the distributive sector. Consumers were forced to save more before they could make purchases of desired items and thus the distributive sector itself was generally unable to expand its credit rapidly.

(c) Cash Reserves and Security Requirements

In the absence of well developed capital markets, where monetary authorities can actively engage in open market opeations, the required reserve ratio is considered the most effective tool available to curb monetary expansion. Thus, the Bank imposed cash resrve requirements to curb commercial bank lending, and supplemented this policy by imposing security requirements which had the added benefit of providing finance for

the ever increasing fiscal deficits. The key features of these restrictions were that

(i) cash and security ratios were never lowered to encouraged lending;

(ii) the Bank used it influence to affect the cost of funds to Government. In general, these cost were kept low, but occasionally as in 1974 and in 1981-82, treasury bill rates were allowed to reflect market rates;

(iii) inspite of the generally low return on treasury bills, banks were willing even in good economic conditions to hold excess government paper.

The initial imposition of cash and security ratios in 1973 came at a time when the banking system was very illiquid. Accordingly, ratios were kept low, but as deposit growth picked up and government revenues could not keep pace with expenditure in the inflationary period, the Bank moved to increase its potential flexibility and to finance government's operations. Prior to 1973, commercial banks had bought small quantities of treasury bills, but in that year they sold their holdings of government paper and forced the government to borrow from overseas. The statutory use of security ratio ensured that this could not reoccur.

By August 1977, the cash ratio had risen to eight percent and the securities ratio to 12% as concern about the effect of

credit expansion on the balance of payments and of the increase in the fiscal deficit surfaced. However, as the economy strenthened no changes were made to the existing ratios. When, however, the balance of payments and the fiscal position deteriorated in 1981-82 the securities ratio rose to 17% and then 19%. The primary effect was to finance a huge fiscal deficit, but the removal of a substantial share of excess reserves guaranteed that potential levels of future credit expansion would be minimized.

1970-73: Pre Oil-Price Shock

Fiscal policy was cautious and conservative during the period although current expenditure rose appreciably, revenue was kept in line. The fiscal deficit was kept to four percent of Gross Domestic Product at current prices except for 1971 when it was 0.4%; due to a reduction in expenditure coupled with an increase in tax revenue. The increase in the deficit for the two following years is largely attributable to a lowering of effective tax rates on incomes in the 1972 budget after dishing out numerous concessions in the 1971 election budget[1] as well as a 35% wage settlement for government employees in 1973.

When judged by the deficit to revenue ratio, it can be seen that on three out of four occasions revenue would have to be increased by 15% or more to have a balanced budget. Emphasis was

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1. The 1971 budget was tax free and included tax concessions.

placed on indirect taxes (mainly trade taxes) throughout the period as each year (except 1971) witnessed increases in import and consumption duties as well as land tax. In 1973 the Common External Tariff was implemented in an effort to offer protection to regional goods but it also assisted in boosting the level of indirect taxes. Although income taxes were eased during the period, it should be noted that the steps which were initiated to ensure more efficient collection resulted in increasing direct tax revenue.

Up to 1973, the deficit was financed mainly from domestic sources. In fact, the foreign debt of Barbados stagnated between 1969-1972. However, due to the size of the 1973 deficit and the unwillingness of commercial banks to finance it in light of better yields elsewhere, Government resorted to Eurodollar borrowings. This marked a new trend in the financing of the deficit. The monetised portion of the deficit to GDP was negligible (understandably so since the Central Bank became operative at the end of the period). That is the change in net domestic credit to Government as a ratio to GDP was small and oft times negative. This would indicate that although expenditure did increase by leaps and bound (6.7% in 1973 and 25.2% in 1973) revenues were generally kept in line. The same analysis is true when we examine the ratio of the change in credit to Government to expenditure since the absence of a Central Bank meant that Government was unable to "print" money.

These first four years witnessed erratic behaviour in the balance of payments. It moved from deficit in 1970 to a surplus in 1971 to deficits in 1972 and 1973. In all the deficit years the current balance for goods and services rose appreciably due mainly to sudden jumps in the imports of goods. In an effort to reduce the demand for imports, quantitative restrictions were introduced, but the impact was small since the restrictions affected an extremely negligle percentage of imports. Throughout the period the EC[1] dollar was pegged to the pound sterling and fell 10% in 1971 when the pound was floated. This devaluation had little impact on our prices or imports since our major trading partner was Britain.

1974-75: First Oil-Price Shock

Concern for the persistent drain of reserves and widening balance of payment deficit took priority and stabilisation policies took precedence over growth objectives. The Central Bank began operations during this period and almost immediately there was a dramatic shift in the financing of the deficit.

After averaging four percent for the first period the ratio of the deficit to GDP rose to 7.2% in 1974. The large fiscal disequilibrium resulted as sluggish output slowed revenue growth (9.5%) while expenditure (22.8%) went unchecked. After the initial burst Government made a conscious trade-off between

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1. The Barbados currency was the EC$ until December 3, 1973.

growth and stabilisation. Two budgets were presented in 1974 - the April budget imposed tight credit, import and foreign exchange policies but was too little to check the fiscal disequilibrium. Thus, as the current account worsened and the deficit expanded, a supplementary budget aimed at reducing these imbalances was delivered in September. It introduced (i) a five percent sales tax on all retail sales except essentials and (ii) the corporation tax to replace the withholding tax. The increase in the corporation tax may have resulted in reduced investment and consequently further contraction in the economy. The sales tax served to reduce consumer demand as well as import demand whilst boosting revenues. The 1974 deficit was largely funded by the Central Bank. The monetised portion of the deficit which was negative for the three previous years jumped dramatically as did the ratio of the change in net domestic credit to Government to expenditure. In fact, the latter moved from -7.7% to 28.0% in 1974, reflecting the significant level of Central Bank financing.

The balance of payments recorded a small surplus ($7.9 million) in 1974 as higher import prices led to a decrease in real import demand while the value of exports increased resulting from improved tourist earnings, an expansion in manufactured exports and a good increase in the price of sugar. The surplus may had been larger had not the terms of trade moved against us in 1973 (6.1%) and in 1974 (8.6%).

The measures taken in the 1974 budget coupled with a doubling of sugar prices and continued strong growth in tourism and manufactured exports led to a significant decline in the deficit/GDP ratio (3.1%) in 1975. Revenue, boosted by a $30 million levy from sugar, grew by 35.6% while expenditure increased by only 14.4%; the net effect was to cut the deficit to half that of the previous year and took pressure off the Central Bank. The ratio of the change in credit to Government to expenditure fell from 28% in 1974 to -0.42% in 1975. This improvement should have been viewed as temporary; due only to the sugar boom.

The balance of payments recorded a substantial surplus ($34.9 million) as a result of the overall economic performance. On July 5, 1975, the Barbados dollar was realigned from the pound sterling to the U.S. dollar; which resulted in an appreciation of 9.7% on the Barbados dollar. There were large speculative inflows between the date the intention was made (May 30) and the date of execution. These inflows boosted the balance of payments during the early months but the position weakened after July 5. The large increase in the price of sugar assisted in increasing the level of reserves as well as moving the terms of trade in our favour by 15.7%. In order to protect the sugar windfall restrictions were put on consumer imports but the overall trade controls were not enough to depress imports.

1976-80: Post Oil-Price Shock

The fiscal stance was expansionary during the first two years and contractionary thereafter. This coupled with poor export performance (the terms of trade fell 12.3% in 1976 due to 24.5% fall in price of sugar) led to a substantial balance of payments deficit in 1976.

The doubling of the deficit in 1976 was due in large part to fiscal improvidence prior to the September general elections. Government, in the face of massive unemployment, decided to introduce crash programmes but did not address the means of paying for the increased cost. The budget (like most election year budgets) did not introduce any new taxes neither did it increase existing taxes and the drop in sugar prices only aggravated the situation. Government expenditure as a result rose by 17.4% while revenue grew by 6.1%; resulting in a deficit of $55.6 million, more than twice that of the previous year. Credit to Government reached record heights as Government tried to finance its programme. Further, the problem may have been aggravated as the new Government kept its election promise, however ill-advised it may have been to abolish the five percent sales tax imposed in 1974. In 1977 the deficit expanded by one-half as the new Government continued the fiscal extravagance of its predecessor. Expenditure continued unchecked and the deficit was contained at $79.5 million only through better collection of taxes. The 1977 budget introduced an employment levy in an effort to put more people in jobs. However, the

success of the scheme remains questionable (doubtful). The budget also reduced corporation tax, placed a surcharge on rental incomes and gave increase allowances and tax credits to individuals.

The financing of the deficit generated some inflation but did not put undue pressure on the reserves as Government borrowed from foreign sources to finance its capital works programme. These two years witnessed an increase in the credit to government/expenditure ratio from -0.42% in 1975 to 17.2% in 1976 to 18.0% in 1977; reflecting the "printing" of money by Central Bank to help finance the deficit. The corresponding ratio of change in credit to Government to GDP was -0.13% in 1975, 5.61% in 1976 and 6.25% in 1977.

The remaining three years of this period were met by a tight fiscal stance although the budgets were slightly reflationary, with the stimulus taking the form of direct tax cuts. The major approach of these three years was reduction in expenditure coupled with increases on indirect taxes to help offset the losses from direct tax concessions. There was a conscious policy by Government to rely on indirect taxes rather than direct taxes. This the dual role of protecting the balance of payments while reducing the tax burden on income earners.

By 1978 the fiscal imbalance was brought under control, with all the major indicators returning to more acceptable levels, as

revenues were bolstered (26.0%) and expenditure checked (4.1%). The deficit to revenue ratio fell from 35.0% in 1977 to 13.6% in 1976 and the deficit/GDP ratio declined from 8.9% in 1977 to 3.9% in 1978. Further both of the monetary indicators of fiscal stance became negative once more; reflecting decreased demand for credit by Government from the banking sector. It would indicate that more funds would be available to the private sector for investment purposes. Revenue growth continued to outstrip expenditure growth during the final two years and the fiscal deficit was maintained at manageable levels. The budgets of these two years were unlike those of the previous three years; tax concessions to individuals, tight expenditure policy and substantial increases in indirect taxes. Throughout the period, emphasis was placed on financing the deficit through external sources. This policy resulted in the foreign debt component growing rather rapidly but this must be seen as the compliment to the reduction in revenues due to the direct tax concessions.

Overall the period was one of growth. It started from a difficult situation in 1976 (See Table 1) but thereafter improved steadily. The improvement was accomplished through fiscal prudence as several revenue raising measures were introduced and a rein put on expenditure. Tax revenues increased from 22% of GDP in 1976 to 28% in 1980 and public savings from 1.6% of GDP in 1976 to 7.0% in 1980.

1976-80 was a period of reserve accumulation; the only reserve loss was in 1976 due mainly to rising government

expenditure. There were sizeable capital inflows in all years except 1979 primarily to finance governments capital expenditure. Thus one witnessed a switch in the structure of as well as a rapid growth in the national debt. Export performance improved as the ratio of exports to GDP increased from 51.2% in 1976 to 70.7% in 1980; reflecting the significant growth in the manufacturing sector especially the electronics subsector. There was a strong resurgence in consumer demand probably the outcome of the abolition of the sales tax. This in turn led to a surge in imports and import licensing and controls were introduced to project the balance of payments. The controls which were rather extensive in 1979 were put on luxuries and non-essentials. The 'negative-list' was introduced and by 1980 a quota of $20 million was placed on automobiles; this followed and complimented the increased tariffs put on in the prior years as well as the tight hire-purchase conditions that were in place.

The terms of trade weakened due to a precipitous fall in the price of sugar and this coupled with a slow recovery in tourism during the earlier years reduced the level of the balance of payments surpluses; leading to further import restraint.

Overall, 1976-80 was an extremely good period for the balance of payments; a little luck in the sugar sector would have made it even better. The current account balance fell from a high of 16.3% of GDP to 3.5% by 1980.

1981-84: Second Crisis Period

The worst fiscal deficit of the entire review period was recorded in 1981 as Government reverted to fiscal extravagance (mainly capital expenditure in an election year). However, immediately after 1981 fiscal restraint was re-introduced and this brought the deficit back to manageable proportions.

Due to injudicious spending by Government in 1981 total expenditure grew by 33.4% compared to a 6.1% growth in revenue. Two budgets were presented. In the first budget personal allowances were increased by 50% and tax credits by 20%. In all tax concessions it cost the treasury $18.7 million whilst the tax take from this budget was $3.1 million; resulting in a net decrease of $15.6 million. As the fiscal position deteriorated a second budget was presented; this sought to reduce subsidies by increasing bus fares, etc, it brought an increased revenue from land tax due to land revaluation, unemployment insurance, imposed a one percent health levy as well as transport and training levies. The slowdown in revenue was mainly attributable to the economic contraction and the recent shift in tax emphasis from direct taxation without fully compensating for them elsewhere. Further, by placing heavy reliance on indirect taxation meant that as the economy contracted so would government revenue. The deficit for 1981 was 10.6% of GDP compared to 3.5% the year before. Once again Central Bank financing increased but not as great as in the other years of high fiscal imbalance.

By 1982, the Government decided to tackle the fiscal equilibrium by cutting back on expenditure. The fiscal prudence may be largely due to the Government's intention to seek balance of payments support from the IMF.

Revenues expanded in 1982 and fifty percent of the increase was derived from the new levies of late 1981. The 1982 budget continued to strengthen the revenue position by placing a surcharge on corporate profits, increased consumption taxes and stamp duties as well as pushing up charges for use of government offices (non-tax revenue sources). In order to further reduce subsidies national insurance contributions were increased as well as water rates.

There was also some tax relief as the minimum taxable salary was increased; removing several thousand from the tax roll. These measures helped to reduce the deficit to 5.5% of GDP.

After two years of decline output stabilised in 1983 and grew in 1984 so Government immediately returned to its enunciated policy of reducing direct taxation; direct taxation which was 8.4% of GDP fell to 5.6% by 1983. The 1983 budget lowered the top tax rate and increased tax credits to lower income owners, but a net gain of $17.6 million was achieved as consumption taxes and stamp duties, airport tax and non-tax measures were all increased. In order to help protect the balance of payments a new travel tax was levied.

The deficit continued to decline and fell to 4.6% of GDP as expenditure rose by 8.1% and revenue by 12.3%. In the 1984 budget tax credits and allowances were increased, the surcharge on corporate profits dropped and land tax fell. However, stamp duties, road tax, consumption and entertainment tax and taxes on betting and gaming were all increased. The budget netted a tax gain of $15 million due to a growth in the tax base. The reflationary 1984 budget suggests that the fiscal stance although stringent had eased slightly since 1982. The overall size of the tax cuts were similar to those of the "pre-crisis" years. By the end of 1984 the deficit to GDP ratio was five percent and the monetised portion of the budget had dwindled. Expenditure grew by 3.6%, as major projects of the previous years were completed, and revenue by 2.7%; reflecting the sluggishness in the economy and the dependence on indirect taxation.

During the final period there were three years of reserve accumulation after a massive balance of payments deficit in 1981; this even after large net capital inflows ($242.6 million). This shows up quite plainly the fiscal improvidence of the Government in 1981. It should be noted that the surpluses of 1982-84 were primarily due to foreign borrowings from the IMF and commercial banks.

Import licensing requirements and quantitative restrictions were the chief tools of the balance of payments policy. Quotas on motor cars were reduced from $25 million in 1981 to $15 million in 1982. These were reinforced by a

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Table 2

Indicators of Fiscal Policy

1970-84

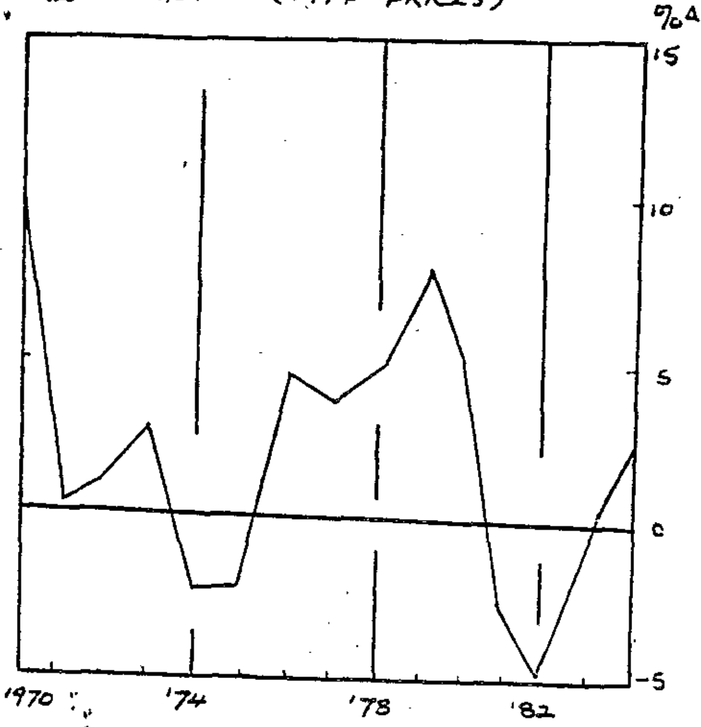
($M)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
(1) a. Total Government Expenditure	105.9	102.1	120.4	150.8	185.2	211.9	256.7	312.6	326.1	395.5	471.8	629.4	586.0	633.3	656.4
b. % Change	n.a.	-3.6	17.9	25.2	22.8	14.4	17.4	17.9	4.1	17.5	19.3	33.9	-6.9	8.1	3.6
(2) a. Total Government Revenue	90.3	100.9	104.9	128.4	140.6	190.6	202.3	227.2	286.2	340.1	420.9	446.6	486.1	545.9	560.6
b. % Change	n.a.	11.7	4.0	22.4	9.5	35.6	6.1	12.3	26.0	18.8	23.8	6.1	8.8	12.3	2.7
(3) Deficit/Surplus	-15.6	-1.2	-15.5	-32.4	-46.8	-22.0	-55.1	-79.5	-38.8	-53.3	-53.3	-181.8	-99.6	-87.4	-111.9
(4) Share of Government in GDP	n.a.	13.8	14.7	14.8	15.2	15.5	14.8	14.3	14.0	13.3	12.7	13.3	13.5	13.5	13.0
(5) (3) - (2a) (%)	-17.3	-1.2	-14.8	-17.4	-32.9	-11.5	-27.2	-35.0	-13.6	-15.7	-12.7	-40.7	-20.5	-16.0	-20.0
(6) (3) - GDP (%)	-4.0	-0.4	-4.1	-4.9	-7.2	-3.1	-7.0	-8.9	-3.9	-4.5	-3.5	-10.6	-5.5	-4.6	-5.1
(7) Change in credit to Government - GDP (%)	0.33	-1.87	-0.56	-2.57	8.09	-0.13	5.61	6.25	-2.03	2.78	0.20	2.40	2.68	-0.64	1.15
(8) Change in credit to Government - Expenditure (%)	0.85	-5.9	-1.7	-7.7	28.0	-0.42	17.2	18.0	-6.1	8.4	0.64	6.5	8.2	-1.9	3.6

(7) Shows the monetised portion of the deficit to GDP
(8) Implies the printing of money i.e. impact of Government on demand by financing through the (banking sector)
n.a. Means not available

Chart I

(a)



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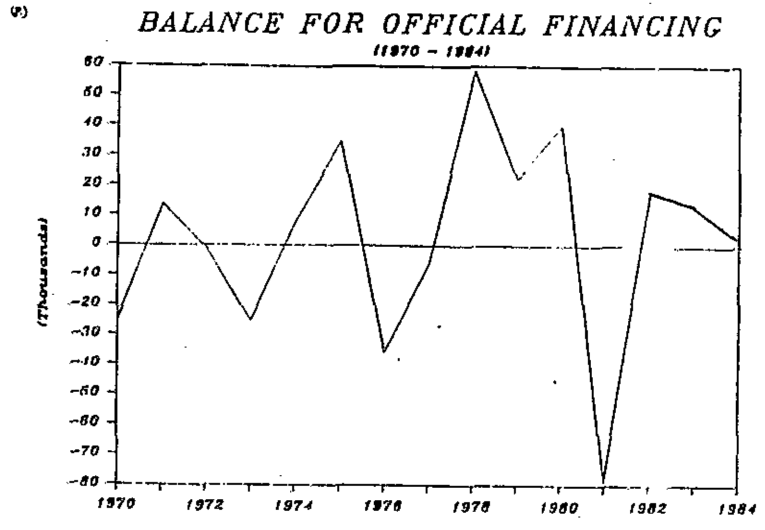

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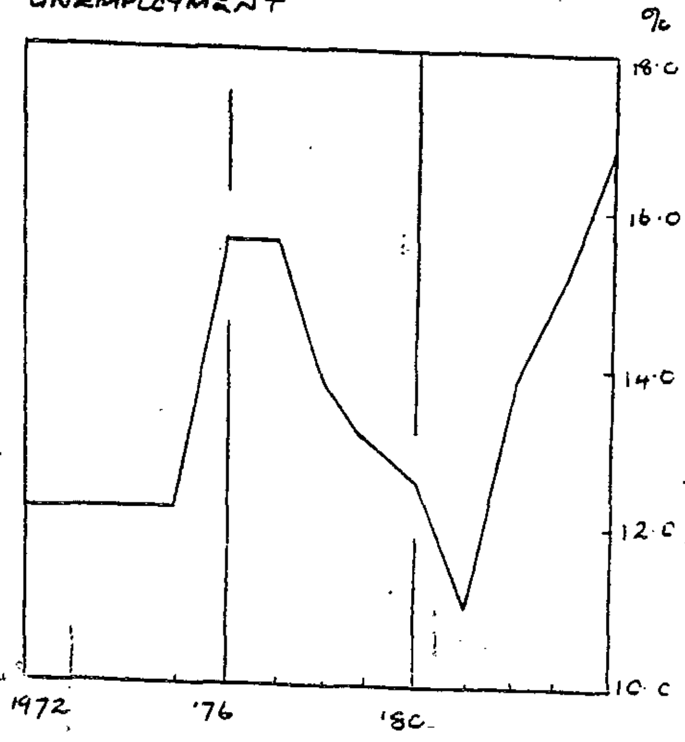

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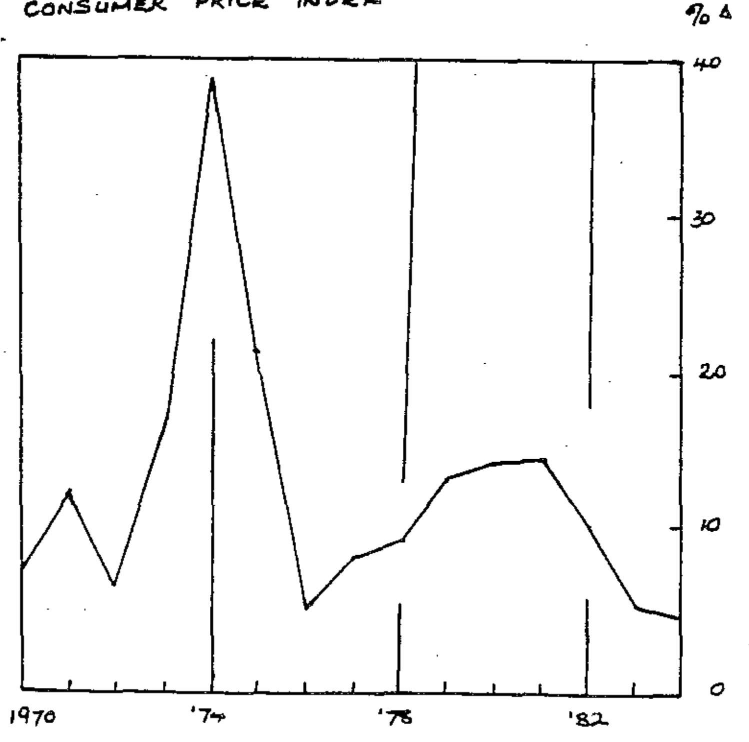
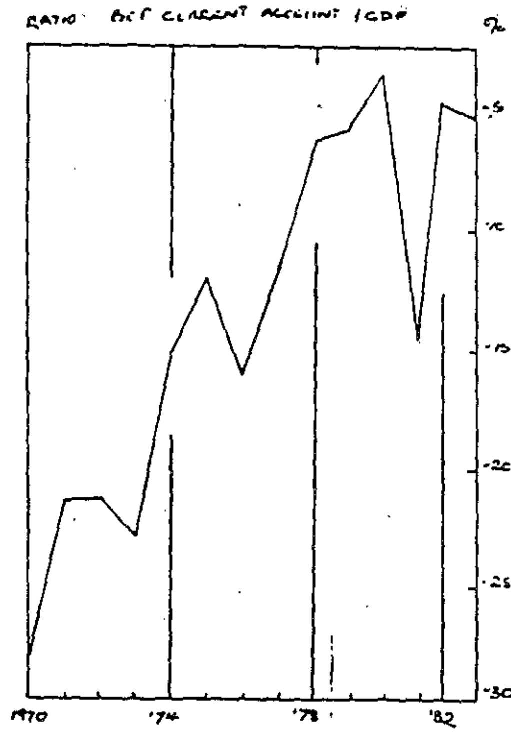


Chart 2

(a)



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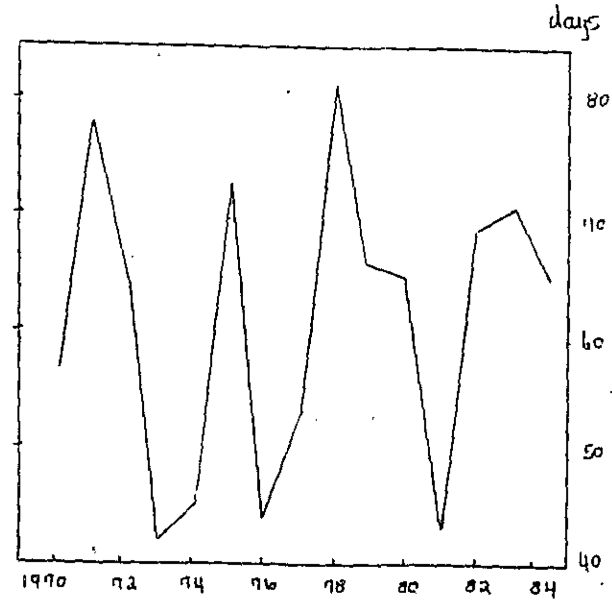


Chart 3(a)

LONG TERM CAPITAL FLOWS

(1970 – 1984)

Long TERM

Public

PRIVATE

(Thousands)

160 150 140 130 120 110 100 90 80 70 60 50 40 30 20 10 0 −10 −20 −30 −40 −50

1970 1972 1974 1976 1978 1980 1982 1984

Chart 3(b)

DEBT SERVICE RATIO

(1971 –1983)

$ MILLIONS

2.6 2.5 2.4 2.3 2.2 2.1 2 1.9 1.8 1.7 1.6 1.5 1.4 1.3 1.2 1.1 1 0.9 0.8 0.7

1971 1973 1975 1977 1979 1981 1983

3(c)

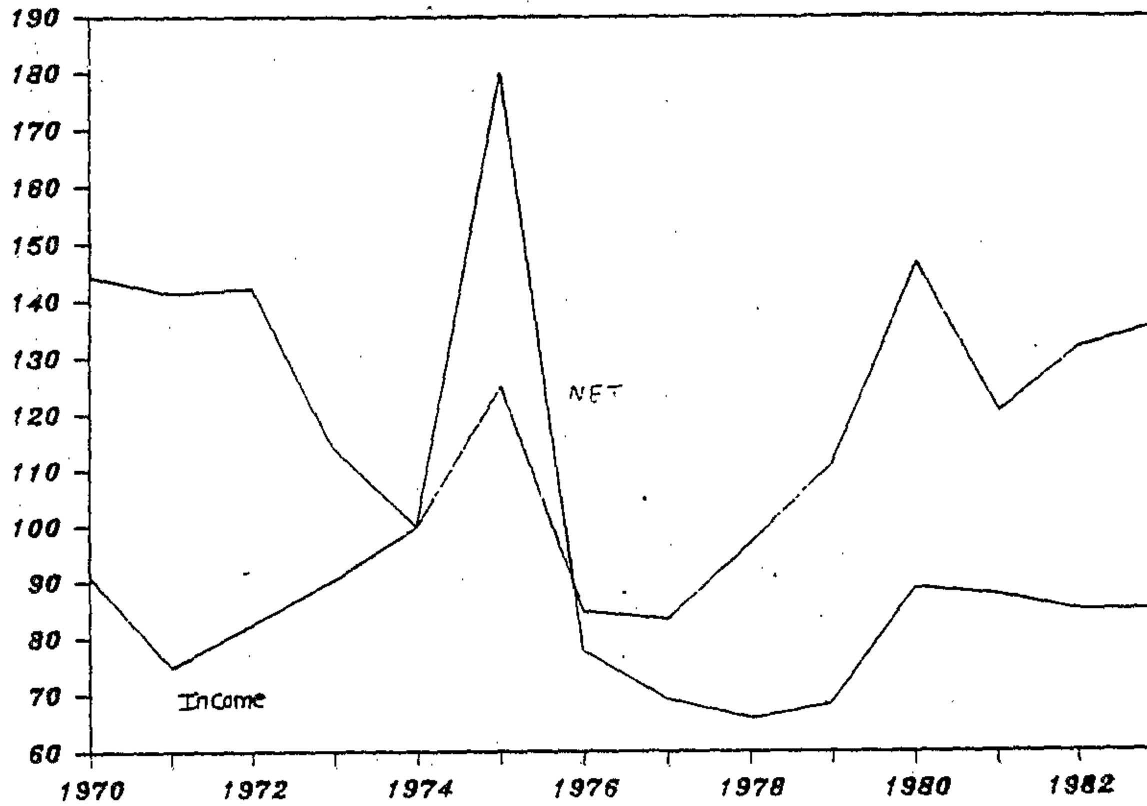
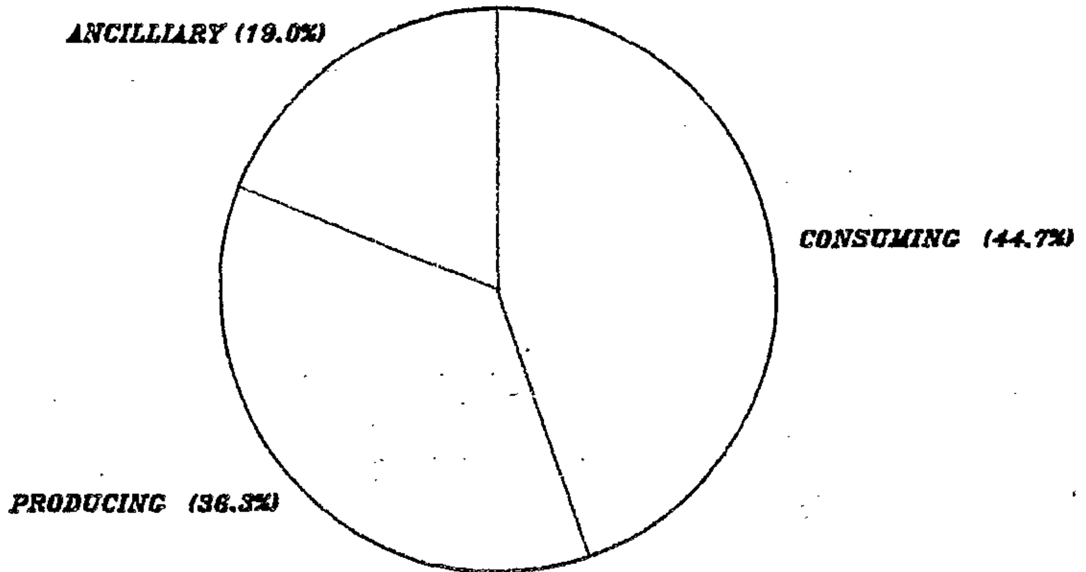


Chart 4

Sectoral Shares of Commercial Bank
Credit (1972)



Sectoral Shares of Commercial Bank
Credit (1984)

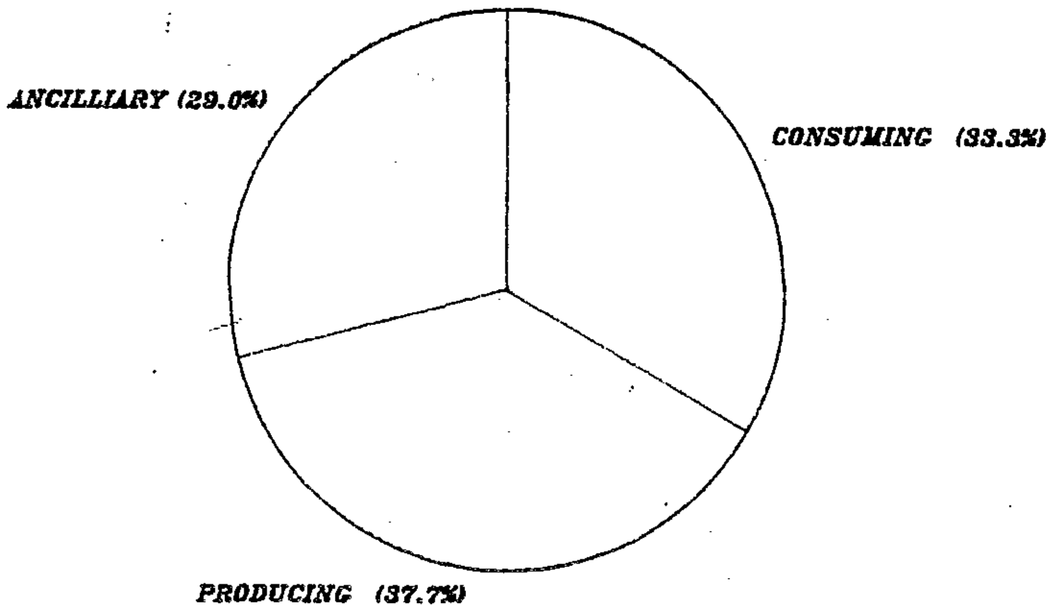
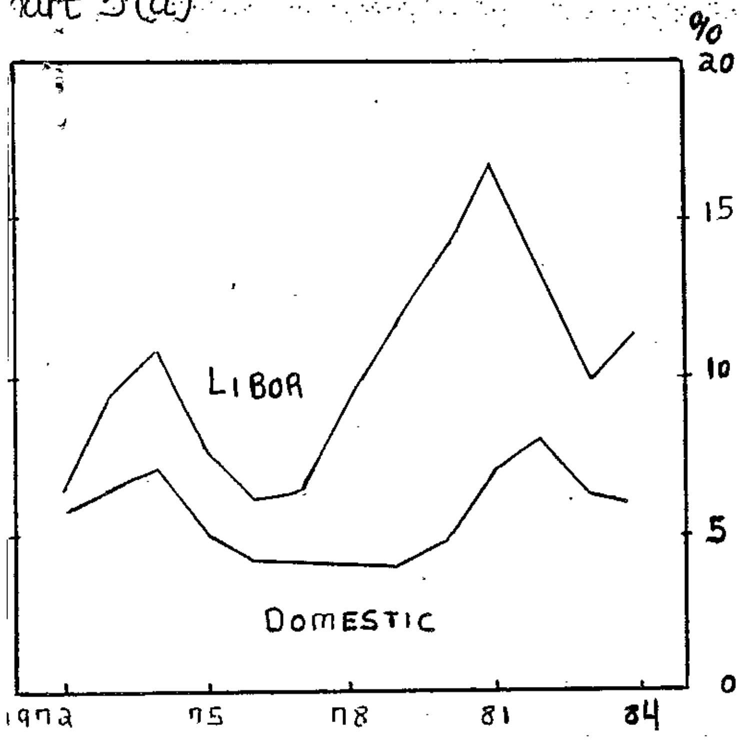


Chart 5 (a) NOMINAL SIX Months RATES



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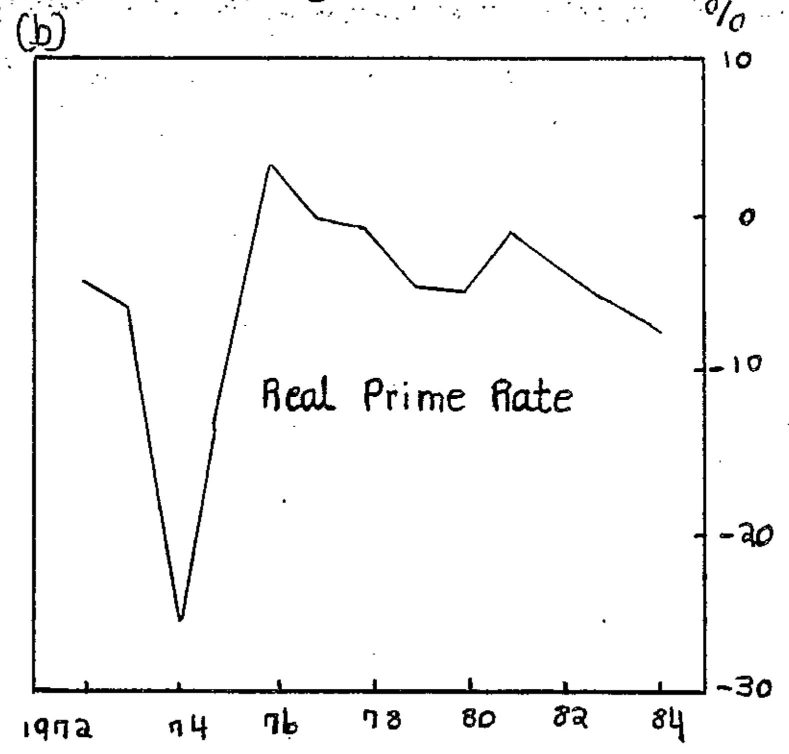

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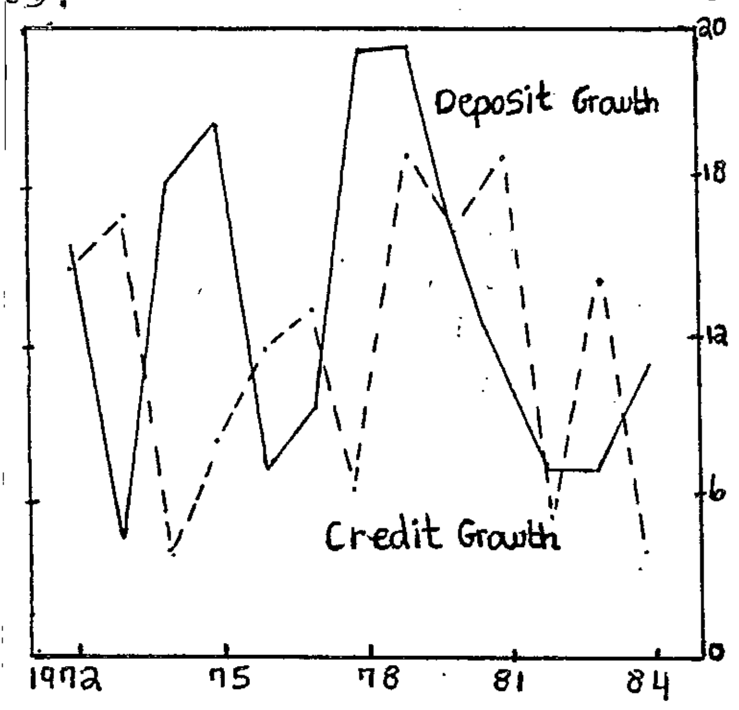

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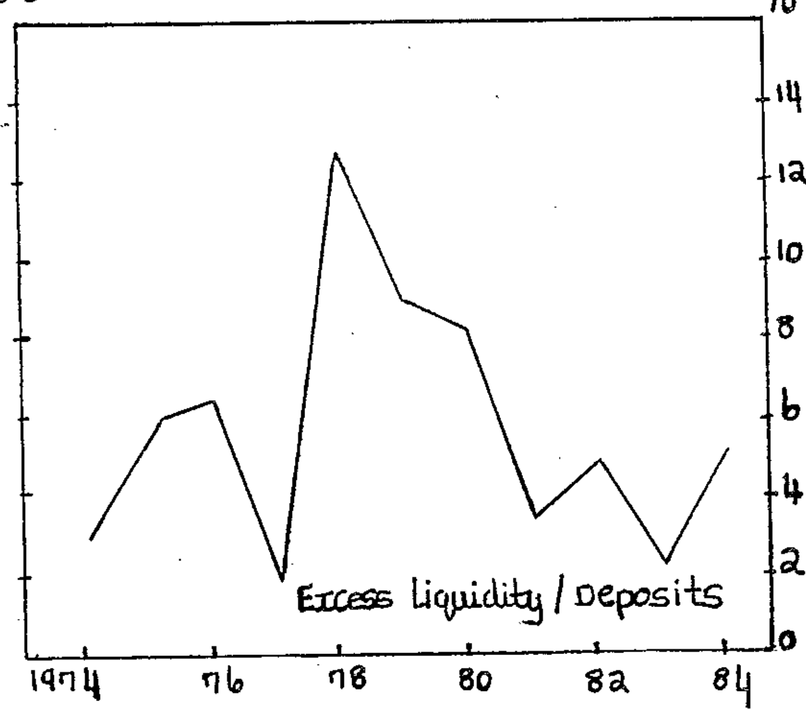


Chart 6

Gov't Revenue and Expenditure

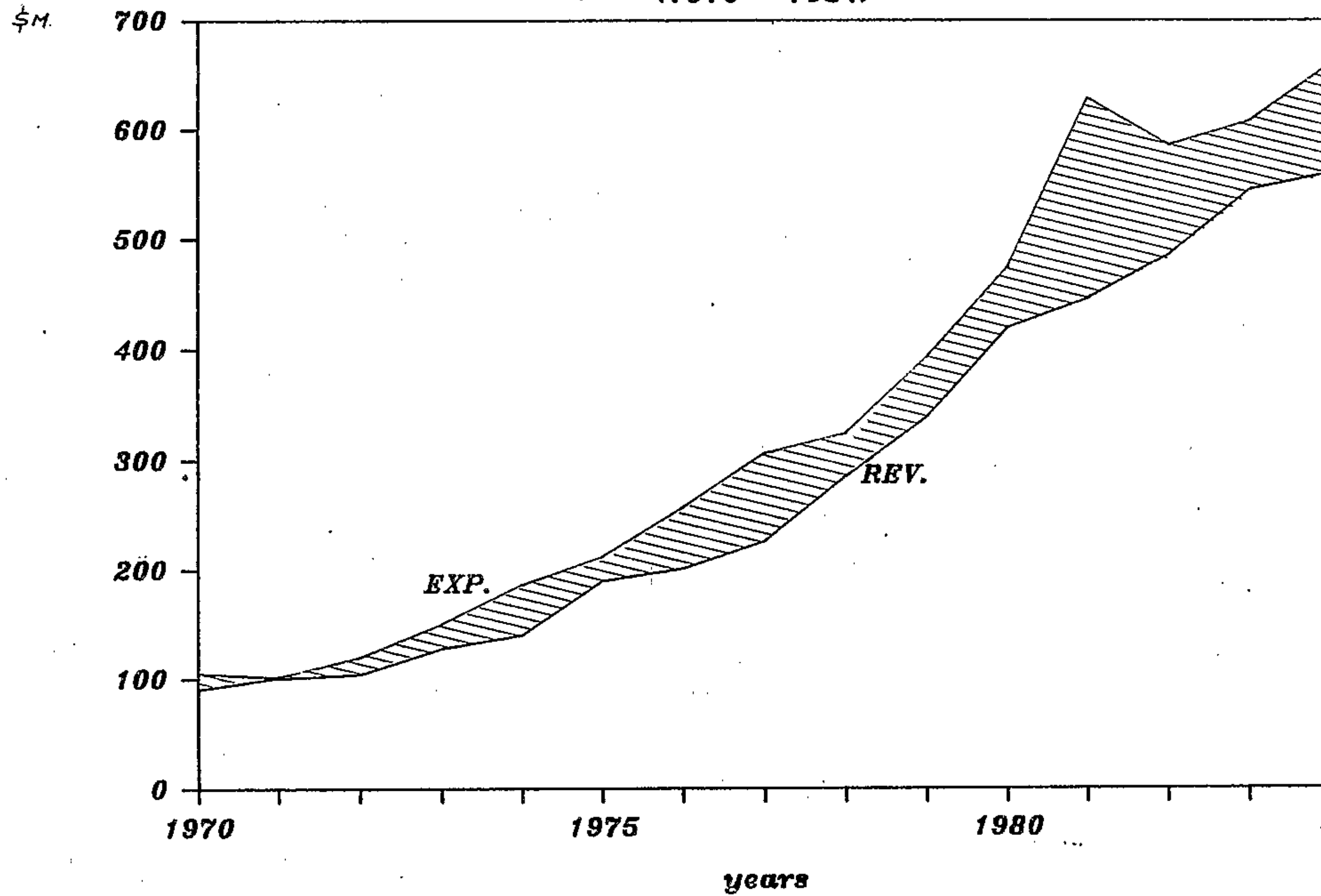


Chart 7

Change in Gov't Revenue and Expenditure

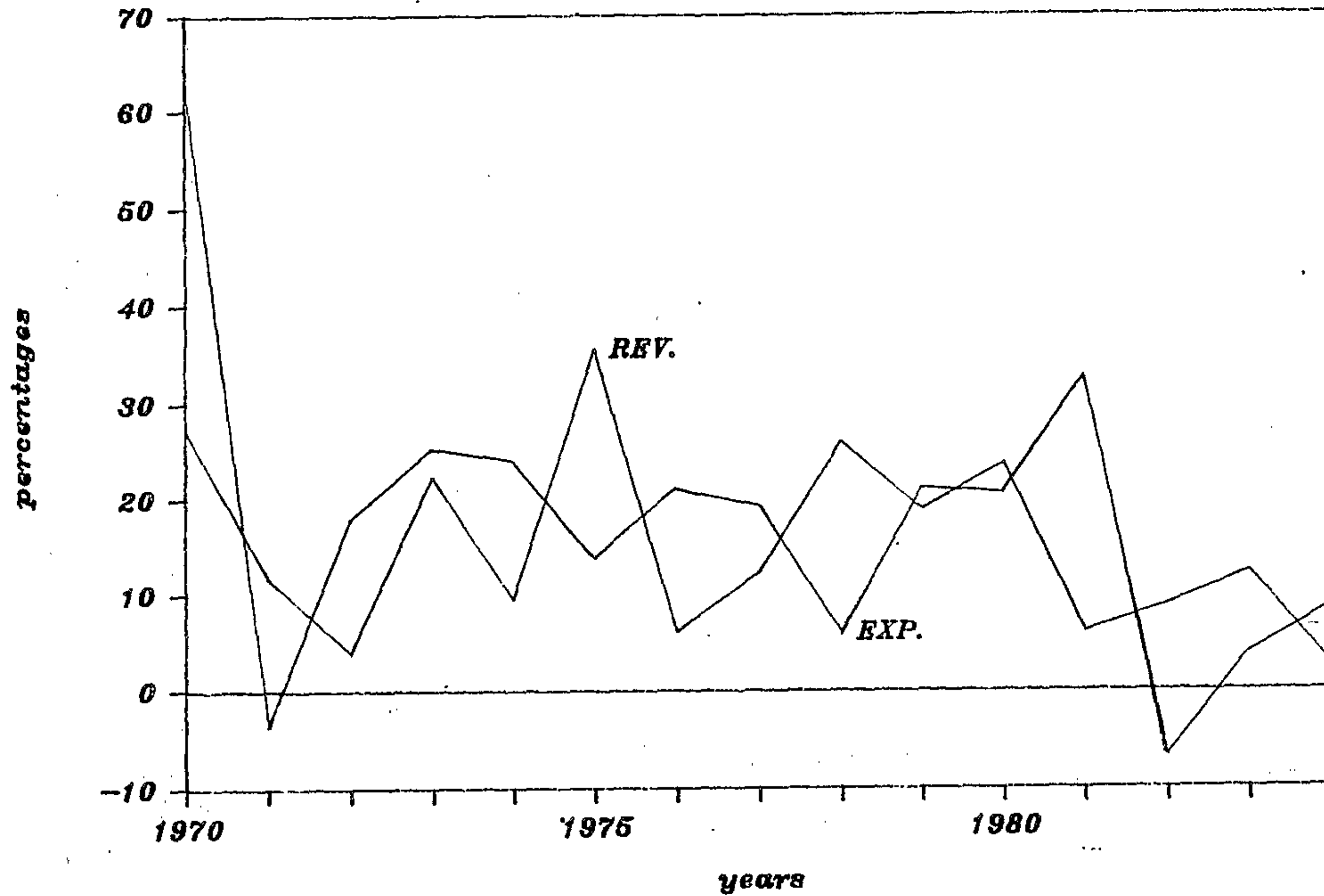
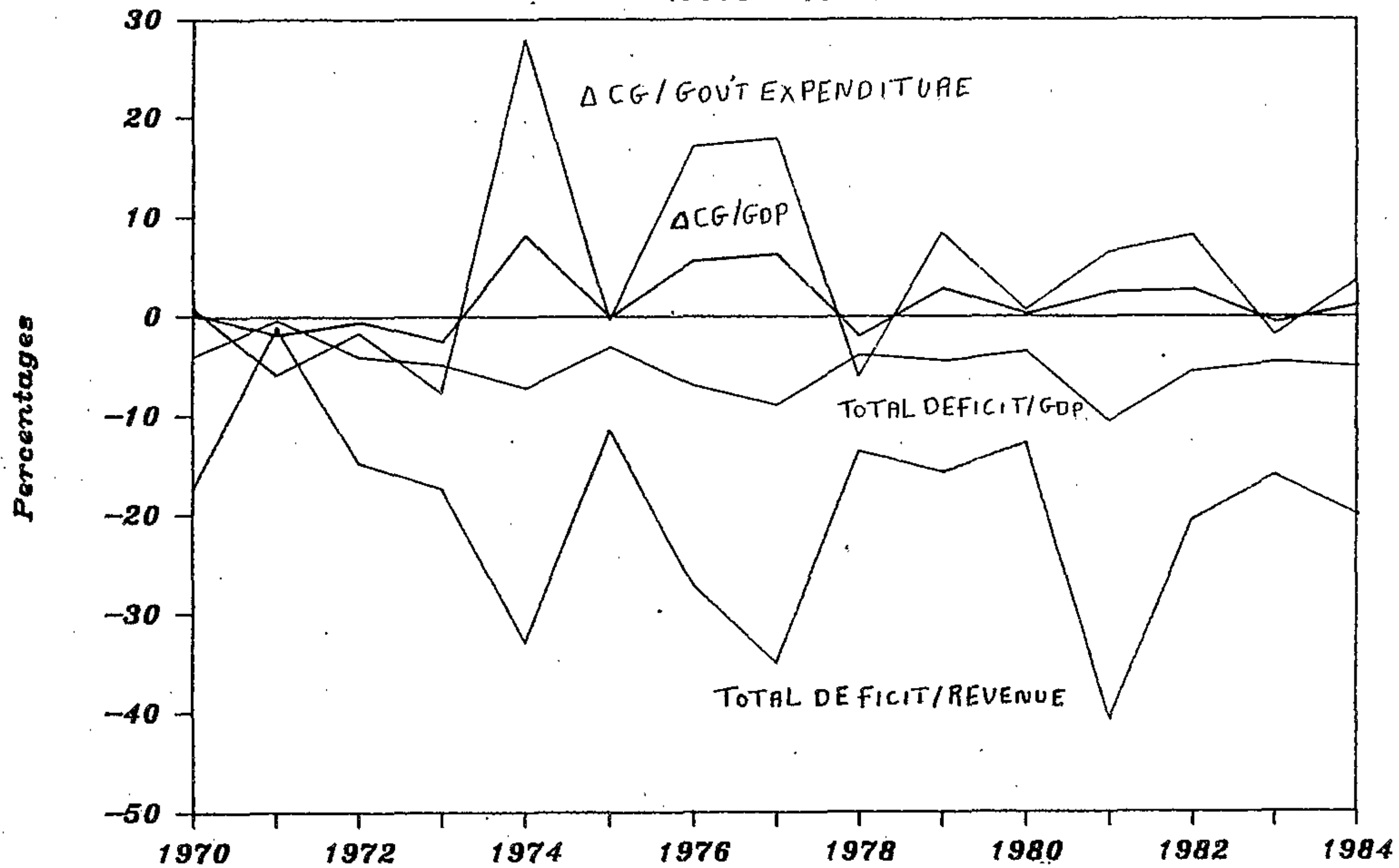


Chart 8

INDICATORS OF FISCAL POLICY

(1970 – 1984)



CG: CREDIT TO GOVERNMENT

GDP: GROSS DOMESTIC PRODUCT

Summary

The Barbados economy experienced four distinct phases of economic activity during the period 1970 to 1984; two of growth and two of crisis. As a result, the ever present possibility of decline led to cautious policies. Emphasis was placed on balance of payments management with the acceptance that the trend in output and prices are, for the most part, determined abroad. Monetary policy proved reasonably effective in controlling private expenditure while fiscal policy, through its ability to expand disposable incomes and provide employment worked towards stimulating economic growth. Sometimes this ran counter to the need to protect the balance of payments.

Finally, we maintain that the economy experienced growth and development although it was setback by the two recessionary periods.