

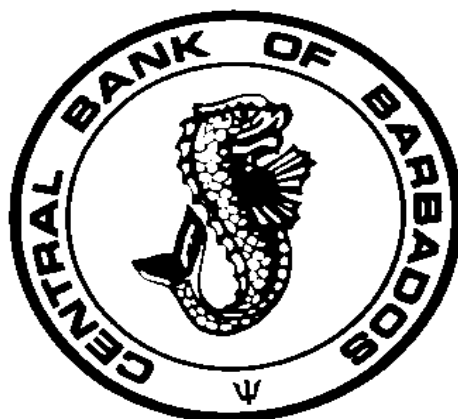
CBB Working Paper No. WP/16/11

The authors would welcome any comments on this paper. Citations should refer to a Central Bank of Barbados Working Paper. The views expressed are those of the author(s) and do not necessarily represent those of the Central Bank of Barbados

**ECONOMIC GROWTH, DEVELOPMENT AND STABILITY IN
SMALL VERY OPEN ECONOMIES**

BY

DELISLE WORRELL



CENTRAL BANK OF BARBADOS

November 26, 2016

Economic Growth, Development and Stability in Small Very Open Economies*

DeLisle Worrell**

Abstract

Small, very open economies (SVOE's) are defined in this paper as those economies with population and total GDP so small and limited that they must specialize in a handful of exports and services to enable them to become competitive on international markets. These countries have negligible scope for import substitution, and an open financial account. These structural characteristics define the policies that are effective in SVOE's: growth is always led by expansion of foreign exchange sectors, which fuel the imports needed for consumption and production; an exchange rate anchor is the most effective stabilisation tool, and it may be sustained with the use of fiscal policy; and the maintenance of an adequate level of foreign reserves defines the limit of fiscal sustainability.

Keywords: Economic stability, exchange rate, open economy, fiscal sustainability, Caribbean, Barbados.

JEL codes: E52, E58, E61, E62, E63

* This paper will be published in a forthcoming issue of the Chinese language Journal of Latin American Studies, published by the Chinese Academy of Social Sciences, <http://www.ilas.org.cn/LatinAmericanStudies/AIL04Z5940B.html>

** The Central Bank of Barbados, Tom Adams Financial Centre, Bridgetown BB11126

Economic Growth, Development and Stability in Small Very Open Economies

Economic growth is generally seen as an increase in real GDP, generated mainly by two factors; an increase in aggregate demand (AD) and an increase in aggregate supply (productive capacity). The productive capacity of a very small open economy (SVOE) is influenced by its peculiarities; namely, small size and vulnerability to exogenous shocks. For SVOE's we lack a solid theory which rationalizes the aforementioned intricacies and their impact on economic growth and stability. In recent years there has been a welcome emergence of an awareness of the fact that small open economies (SOE's) face challenges that are different from those of large countries. Groups to study the peculiarities of SOE's have been formed by the IMF, World Bank and United Nations, and the Commonwealth Secretariat. As a result of work done by these interest groups among others, it has been established that SOE's; are more dependent on international transactions than larger countries, have limited diversification prospects and a narrow range of exports; have limited domestic competition, are unable to influence international prices, lack natural resources, and are exposed to high international transport costs. This research has also established that SOE's may grow and develop just as successfully as larger countries, provided that they institute policies to strengthen the economy's resilience, enhance governance, facilitate increases in social development, advance market efficiency, and improve macroeconomic stability (Briguglio, Cordina and Kisanga, 2006).¹

The thesis of the present essay is that the analysis of the economic circumstances and development prospects of what I call small *very* open economies (SVOE's) must be deepened to provide useful insight about the policies that are efficacious in accelerating their growth and development, and ensuring their economic stability. As far as I am aware, this work have not being done, by any of the small economy groups set-up by international institutions. In fact, the IMF and World Bank have not distinguished between small countries and large in their policy prescriptions. The same suite of policies is expected to produce similar results in Barbados and Brazil, because they are both categorised as emerging market economies, even though Brazil has a population that is over six hundred times as large as Barbados. This essay explains why size

¹ Briguglio, Lino, Gordon Cordina and Ellawony Kisanga, *Building the Economic Resilience of Small States*, University of Malta and the Commonwealth Secretariat, 2006.

makes a difference to the economic policy choices that countries have, and sheds light on the strategies that have proven to be most successful for SVOE's.

The defining characteristics of the countries we classify as SVOE's is that they have populations and gross national incomes so small that they lack the capacity to produce (at internationally competitive prices) more than a handful of the goods and services a modern economy needs. Also, their populations have widespread access to modern telecommunications, so it is impossible to close the capital and financial account, and ration the inflows of nontrade transactions.

The implications of these features of the economic structure of the SVOE are:

- The possibilities for growth through import substitution are very few, and imports are insensitive to price changes.
- The SVOE has no influence on the prices in the international markets in which they sell goods and services. They must match the prices of competitors who are selling products of similar quality, and at those prices they can sell everything they produce. They are limited not by price but by the rate of investment in productive capacity.
- The monetary authority has no capacity for independent monetary policy because of the general availability of avenues for international financial transactions. Attempts to use monetary tools for domestic policy purposes inevitably are negated by capital flows, through formal or informal channels.

These structural characteristics have important implications for the policy options that SVOE's face. In what follows we explain our preferred strategies of SVOE's for economic stabilization, economic growth and economic development, and how these strategies differ from the orthodoxy.

With respect to *economic stabilisation policy*, the preferred strategy of SVOE's, sometimes openly admitted, but often reflected in the observed performance even though not officially proclaimed, is an exchange rate anchor. Exchange rate anchors were at one time popular, but they fell from favour because countries did not find a way to protect the anchor in the face of

flows on the capital and financial account. We point to an alternative to the standard adjustment policy prescription of flexible exchange rates and independent fiscal and monetary policies. We contrast the strategy we recommend, which involves the use of fiscal policy to achieve a balance of external payments and a sufficient store of foreign exchange reserves to ensure that the monetary authority can supply the day-to-day needs of the foreign exchange market. In fact, it is desirable to have foreign reserves well in excess of transactions needs, to allow time to make adjustments to fiscal policy should there be an event - such as the global recession - which depresses the supply of foreign exchange and puts the external accounts into negative territory.

An often repeated element in guidelines for economic growth is for diversifying the mix of domestic production. The small size of an SVOE's population means that the available pool of skills cannot stretch beyond a limited group of activities in which the country can demonstrate a comparative advantage. We shall show that levels of concentration in exportable goods and services are very high, for SVOE's. This does not limit the growth possibilities for SVOE's, however. They may expand production by investing in product enhancements, penetration of new markets, higher productivity and upgrading the quality of products sold in international markets.

In order to translate economic growth into sustained development it will invariably be necessary to adopt new technologies, penetrate new markets, develop new techniques of organisation, and build new skill banks. It may also be necessary to implement social strategies to cope with employment transitions as a result of technological and organisational change, migration, environmental consequences, and demographic changes. These depend on a state-directed strategy which provides the incentives, funding and other support needed to bring these activities to a minimum threshold for self-sustaining growth. This need for state promotion of development strategies is universal. What is especially challenging for SVOE's is that they do not have the luxury of introducing development strategies in the local market, behind protective walls of tariffs and non-tariff barriers. The domestic market is too small to support the output of any sectoral activity which has the potential to be internationally competitive. Businesses that are cultivated behind protective barriers in SVOE's all too often fail as soon as they are required to compete on the international market. The special challenge for SVOE's is to launch innovative techniques and organisation on a global stage, right from the start.

Defining the SVOE

In a recent paper, two colleagues and I use population size and size of US dollar GDP as indicators, and rank countries from smallest to largest by both indicators, in order to determine a cutoff point below which a country might be classified as an SVOE. To determine the cutoff points, we compared the potential for import substitution of a comprehensive selection of small countries with a sample of very large countries. The import substitution potential varied by country, but there is a noticeable tendency for small countries to have lower potential than for large countries. One threshold used is based on this comparison of estimated import substitution potential, for the two groups of countries. All countries in the cluster with the lower estimated potential for import substitution were included in the SVOE group.

The selection was further validated with reference to measures of concentration in the export of goods and services. On examination we found a cluster of countries with relatively high concentration ratios, and any country within this cluster that was slightly above the threshold for import substitution capacity was added to the list.²

How to anchor the exchange rate in SVOE's

SVOEs need an alternative to inflation or monetary targeting with a flexible exchange rate (the standard recipe for stabilization policy), because both the domestic interest rate and the exchange rate are governed by short-term financial flows.³ Such an alternative is available in the form of the market-determined exchange rate anchor,⁴ managed by containing aggregate spending (and therefore imports) through timely forward-looking fiscal adjustment. In effect, the external accounts are managed by controlling the fiscal contribution to aggregate expenditure. Fiscal targets are derived from a forecast of foreign exchange inflows and the forecast impact of fiscal policy on aggregate expenditure and imports. A continuous monitor of the balance of payments is maintained via the foreign exchange reserves of the central bank, which buys any foreign exchange in excess of the system's needs, and sells on demand, always at the same

² DeLisle Worrell, Winston Moore and Jamila Beckles, "'Size, structure and devaluation," Central Bank of Barbados Working Paper, March 2015.

³ DeLisle Worrell, "Monetary Policy in Small Open Economies," Central Bank of Barbados Economic Review, 24(2): 13–18, 1996. This paper concludes that monetary tools such as interest rates and credit limits have temporary effects at best.

⁴ The choice of anchor will depend on the direction of foreign trade and finance of the SVOE. For most countries, it will be the currency of a dominant neighbor, but countries such as Singapore have used a basket (see Eric Parrado, "Singapore's Unique Monetary Policy: How Does it Work?," IMF WP/04/10, January 2004).

exchange rate. This continuous monitor is evaluated against the year-end target, taking account of seasonalities, and from time to time fiscal adjustments are made as needed. The advantages of this framework are that the predictability of the exchange rate is highly valued by economic agents, and the ability to keep the rate unchanged over the long term lends credibility to economic policy. Conversely, a history of exchange rate fluctuation often robs economic policy of credibility, even when the policy is well thought out. A second advantage is that the lack of exchange rate volatility has long been known to be a strong incentive to investment.⁵ Third, an exchange rate anchor is an effective anti-inflationary policy, because it does not aggravate the effects of imported inflation.⁶ The exchange rate is a highly visible target, one that is recognized by everyone, and one whose inflationary consequences are feared by everyone.

Exchange rate targeting was at one time quite popular, and many countries attempted strategies ranging from targeting an unchanged rate to various degrees of floating.⁷ What my proposal shares with those strategies is the achievement of the target, in this case an unchanged rate, by means of intervention in the interbank foreign exchange market by the central bank. What is added is the management of aggregate demand via fiscal policy as the means of equilibrating the foreign exchange market, and ensuring that the central bank always has an adequate supply of foreign reserves to support the interbank market at the target exchange rate peg. This process of foreign exchange market adjustment is shown in the figure below, which plots foreign exchange demand and supply against aggregate domestic spending.

The higher is aggregate spending, the higher will be the demand for foreign exchange (FX). In the short run, for reasons just explained, the supply of foreign exchange is invariant to policy. Therefore, if the expected demand for foreign exchange is at point A, aggregate demand must be reduced sufficiently, using fiscal policy, to reduce foreign exchange demand to point B.⁸ As a practical matter, this means that decisions on fiscal adjustment should be taken well in advance of the expected excess demand, and there should be a robust mechanism of monitoring the

⁵ Robert Pindyck, "Irreversibility, Uncertainty, and Investment," *Journal of Economic Literature*, 29 (3): 1110–1148, September 1991.

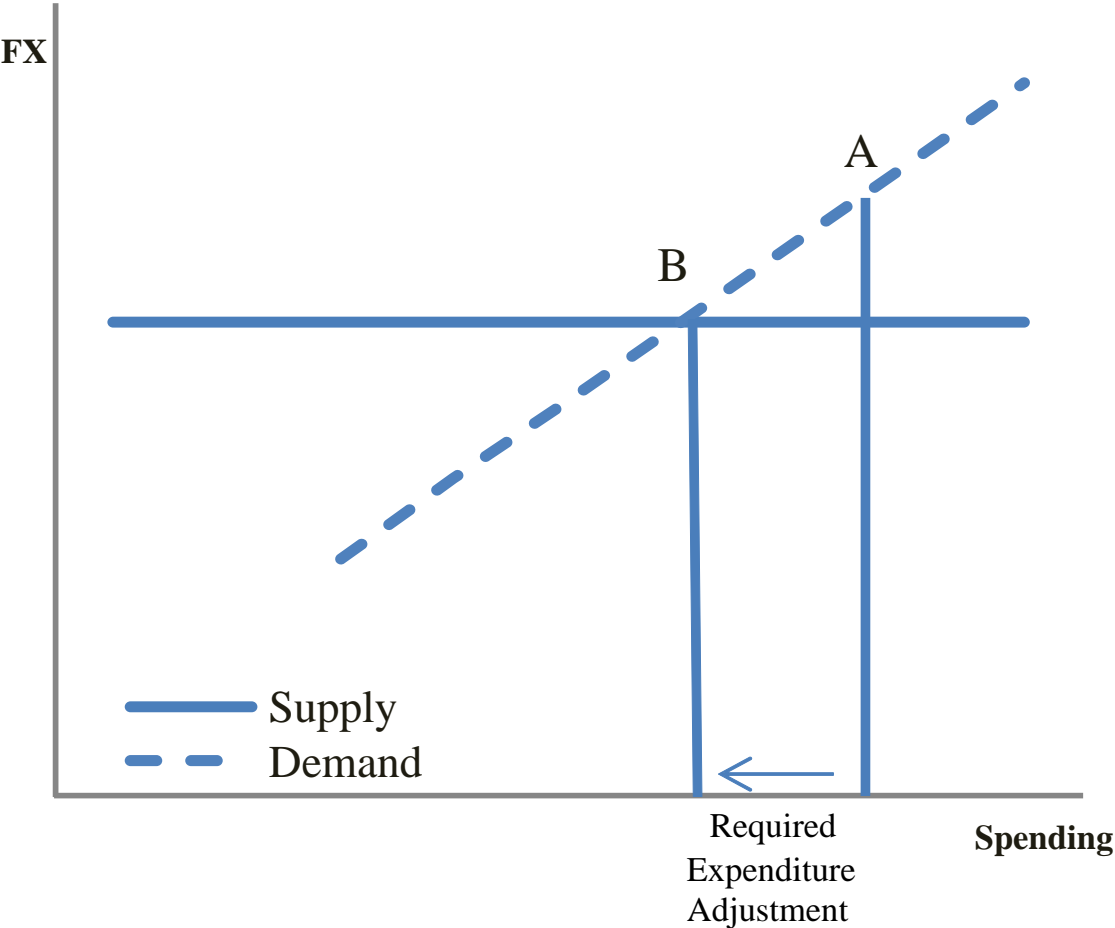
⁶ In effect, the SVOE may borrow credibility from the anti-inflationary policies of the anchor country.

⁷ See Carlo Cottarelli and Curzio Giannini, "Credibility without Rules? Monetary Frameworks in the Post Bretton Woods Era," IMF Working Paper, 1997.

⁸ A model of the impact of fiscal adjustment on aggregate demand appears in Anton Belgrave, Jason LaCorbiniere, Delisle Worrell, and Denisa Applewhaite, "Fiscal Sustainability in an Open Economy with an Exchange Rate Peg," *Central Bank of Barbados Economic Review*, March 2011. Other frameworks may be used to estimate the impact of fiscal adjustment on aggregate demand and imports. The argument is not model specific.

external balance and feedback to the policy makers, so that corrections can be made from time to time to keep the foreign exchange market on course.⁹

Figure 1: How to balance supply and demand for foreign exchange using fiscal policy



Fiscal sustainability

An approach to measuring fiscal sustainability which reflects the behaviour and policy preferences of a typical small open economy (SOE). As far as we know, this approach is novel and unique as the fiscal risks of SOEs are not only motivated by their chosen method for financing the fiscal gap, but also the peculiarities which characterises the economies. Small open

⁹ A description of the institutional arrangements used in Barbados appears in Delisle Worrell, “Stabilisation Policy with a Fixed but Market-determined Exchange Rate,” Central Bank of Barbados Economic Review, June 2012).

economies are characterised by their high propensity to import. Inflationary pressures manifest themselves in increased demand for imports and foreign exchange. Fiscal expansion drives up aggregate expenditure and generates inflationary pressure. This manifests itself in a deterioration of the external balance. Fiscal expansion becomes unsustainable when the pressure on the foreign exchange market intensifies to the point where it triggers a balance of payments crisis. Such a crisis will trigger adjustments, involving a loss of real income and will be characterised by high inflation, the widespread use of informal markets and a general loss of investor confidence. We propose a fiscal sustainability assessment tool that uses this threshold to define the sustainability limit.

The International Monetary Fund (IMF) Debt Sustainability Analysis (DSA) framework uses as its starting point the proposition that, what limits fiscal space is the level of debt. This is the conventional notion, and it is based on the thesis that beyond a certain threshold, the level of debt becomes a drag on growth. Debt by itself, does not constrain fiscal expansion, as is evident from recent experience. Governments may and do choose to grow debt beyond the threshold, in spite of the fact that this will slow growth (if indeed it is true that there is an optimal value of debt to GDP, which remains controversial). Since the financial crisis of 2008, most countries, emerging and industrial, have had debt to GDP ratios well in excess of the commonly recommended optimal thresholds. Ironically, policies designed to reduce the outstanding levels of debt involve fiscal cutbacks which depress growth, as a consequence the debt to GDP ratios tend to remain stubbornly high, in the face of best efforts to reduce them. The policy stance which too often emerges from the conventional DSA therefore leads to a policy contradiction: there is a need to cut fiscal deficits to pay down debt, but the ensuing depression of GDP makes it difficult to get the ratio down.

Our recently published book *Fiscal Sustainability and Debt* proposes an alternative measure of fiscal space, and for assessing of sustainability. The approach focuses on the impact of fiscal policy on aggregate spending. Noteworthy, it is the impact of fiscal policy and public finance on aggregate spending, rather than the level of Government indebtedness, that in practice constrains fiscal space and sets the limits to fiscal sustainability. This can be explained by considering the impact of government spending. For instance, consider a situation in which Government spending exceeds revenue by \$100 million. If Government is able to fully fund this deficit with

the issue of domestic bonds, there is no impact on aggregate expenditure, because the purchasers of the bonds buy them with savings diverted from the domestic consumption stream. Therefore, aggregate private spending is reduced by the same amount as the additional funding to Government.

The issue of Government bonds abroad provides an inflow of foreign funds to finance any additional imports that result from the increase in Government spending hence there is no additional pressure on the foreign exchange market. The additional government spending has no effect on fiscal space in either of these two circumstances, because neither provokes any increased pressure on the balance of payments. However, if Government is unable to attract buyers for its bonds at market rates, which usually happens when overall fiscal policy is considered inappropriate by markets, Government is obliged to fund the additional spending by money created by the central bank, or by the accumulation of arrears. In either case there is an inflationary impact on the economy, and it is this inflationary impact which reduces fiscal space and leads to unsustainable position. In the case of the small open economy, the inflationary pressure may manifest itself as an increased demand for imports, a reduction in foreign exchange reserves and a depreciation of the exchange rate. In the event that the pressure on the foreign exchange market intensifies to a point where it triggers capital flight and unanticipated currency depreciation, it is evident that the fiscal expansion is unsustainable.

This, then, is the logic of the approach to debt sustainability embodied in the book *Fiscal Sustainability and Debt*, and is the main thrust used in the development of the “Fiscal Sustainability Tool” which this paper describes. The tool is intended for use in small very open economies (SVOE), where the import propensities are high and the potential for substituting home production for imports is very low. In such economies the impact of fiscal expansion on the foreign exchange market is large and direct.

We define the sustainable frontier in terms of the exchange market pressure generated by the fiscal stance as manifested in the size of the fiscal deficit. The limit of sustainability is reached when the exchange market pressure resulting from the fiscal deficit reaches a level that triggers capital flight and fear of a chaotic devaluation. The service payments on government's external debt are a second source of potential balance of payments difficulty. External borrowing to

finance fiscal expansion is in general preferable to domestic borrowing because it brings additional foreign exchange to cover the additional import spending that ensues, but there is a limit when the servicing additional external debt drives the pressure on the foreign exchange market beyond the trigger point. Our methodology combines the impact of the foreign debt service and the fiscally induced demand for imports, to assess the total effects on the balance of payments.

The tool allows us to measure fiscal sustainability by considering:

- The expected level of foreign exchange reserves, which is the most accessible and closely watched financial indicator;
- The expected foreign financing of the Government deficit and the cost of servicing that additional foreign debt, so that a forecast can be made of the net effect on foreign inflows;
- The expected domestic private financing available at market rates, and the unfinanced amount that will have to be funded by the central bank or the accumulation of arrears; and
- An estimate of the additional demand for imports that will arise from the additional Government expenditure.

Armed with this information, we may derive the impact of the additional expenditure of \$100 million on the level of foreign exchange reserves. The new level may then be compared with what is perceived to be the threshold level, which varies from country to country, and depends on local market perceptions and preferences. The deficit is unsustainable if the additional expenditure drives foreign exchange reserves below that threshold; it is sustainable otherwise. The approach that measures sustainability in this way is intuitively appealing: the deficit becomes unsustainable when it raises the probability of a balance of payments crisis to a level beyond the market threshold. It comes with a single readily available indicator: the projected level of foreign exchange reserves. Moreover, un-sustainability by this measure means the policy cannot be persisted with, because a crisis will ensue.

Comparing the fiscal sustainability analysis (FSA) with the debt sustainability analysis (DSA)

When comparing the fiscal sustainability analysis (FSA) (i.e the approach proposed in our paper) with the debt sustainability analysis (DSA) one can clearly note that the FSA is more powerful. This conclusion is based primarily on three arguments. Firstly, the FSA uses a market-based threshold, in contrast to the DSA. When fiscal expansion creates exchange market pressure of an intensity that drives foreign reserves and/or the rate of depreciation beyond levels with which markets are comfortable, there will inevitably be a balance of payments crisis. Balance of payments crises in SVOE's are very difficult to correct, and they often damage economic development prospects. Secondly, the DSA thresholds are abstract, and there is no consensus on where those thresholds ought to be set. Thirdly, the FSA avoids the contradiction inherent in policies based on achieving a DSA ratio, i.e generating a fiscal surplus to lower the amount of debt depresses GDP. The rationale for this conclusion lies in the relationship between the numerator and the denominator. Note well, if the denominator shrinks then the numerator is driven down, hence it becomes harder to lower the ratio.

A country using the FSA methodology may find that it is not necessary to achieve an overall fiscal surplus to relieve pressure on foreign reserves, and that surpluses on the fiscal current account will suffice. That is not to say the FSA will suggest a way to avoid fiscal austerity. On the contrary, whenever foreign market pressure is excessive, fiscal contraction is necessary, and it must be sufficient to relieve the foreign exchange market pressure. That does invariably mean a fall in GDP, but such a decline is inevitable, because there are insufficient foreign currency inflows to satisfy the demand for imports at the current rate. That is the reason for the excessive foreign market pressure, and imports can only grow when there are additional inflows.

In principle the FSA and the DSA are complementary, if the FSA is interpreted as the measure of sustainability, and the DSA can be interpreted as indicating the optimal level of debt. SVOE's needs to achieve sustainable fiscal strategies that steer them clear of balance of payments crises. Having successfully done so, they may then wish to reduce the burden of debt service, in order to create more fiscal space.

Competitiveness and growth

The foreign exchange constraint, and the fact that it cannot be relieved by an exchange rate depreciation, limits the overall rate of growth of the SVOE to the maximum that can be supported by the foreign exchange surpluses of the tradable sectors. All production in the SVOE has a high import content, both tradables and nontradables. The nontradables, which earn no foreign exchange, use the tradables' surplus of foreign exchange over their own needs and the needs of consumers, to buy imported inputs. If that surplus is reduced for a year or two, it may be possible to finance the difference by foreign borrowing or running down reserves, but eventually the growth of nontradables will slow down if the tradable foreign surplus is not restored.

The foreign exchange constraint on growth may not be alleviated by an exchange rate depreciation because of the low substitutability of nontradables for tradables. The (often temporary) increase in the relative price of tradables that results from the depreciation provokes no switch of consumption from tradables to nontradables because education or health or other nontradables cannot be substituted for tourism or other tradables. The range of tradables in which there is competitive domestic production is very narrow, as previously noted, and therefore there is no significant scope for import substitution (or expansion of tradable output to meet local needs instead of exporting).¹⁰ In cases where an exchange rate depreciation is seen to reduce the excess demand for foreign exchange in the SVOE, it will be observed that the real demand for imports has fallen because of the income effect of the depreciation, but there has been no substitution effect.¹¹ The depreciation makes imports more expensive, without creating any avenue for an increase in income, either in the production of tradables or nontradables, and therefore fewer imports can be afforded.

An exchange rate depreciation in an SVOE does not typically result in any increase in output, and may precipitate a contraction. The depreciation does not increase the country's competitiveness, even in cases where there is less than full pass through to the prices of domestic goods and factor prices, if competitiveness is judged by market penetration, or, in this

¹⁰ The latter would in any case be unhelpful, because it would not help to alleviate the foreign exchange constraint.

¹¹ Depreciation is therefore an inferior tool for achieving what may be effected at lower inflationary costs by appropriate fiscal adjustment, at an unchanged exchange rate (DeLisle Worrell, *Economic Policies in Small Open Economies: Prospects for the Caribbean*, Commonwealth Secretariat, 1992, p. 53).

case, output growth. Conventional real effective exchange rate measures, which combine exchange rate changes and changes in relative prices at home and abroad, are indexes of a more limited concept of competition, where the least costly is the most competitive. What is more, they are not a good proxy of the offer price of domestic products. The SVOE sells tradables at the ruling international price, whether at home or abroad. It is only in the nontradable sector that producers may sell at prices that are not fully determined abroad. The ratio of tradable-to-nontradable prices is therefore the most useful proxy of price competitiveness in SVOEs.

Competitiveness for SVOEs is not about relative prices. Growth strategies for SVOEs are by necessity country specific, and depend on the production structure and composition of the foreign exchange sector, and the sources of the country's comparative advantage.¹² In a world of rapidly changing tastes and technology, where new products and new competition are constantly emerging, it is more likely that structural changes will drive the relative prices of nontradables than the other way around. In any case, a sustainable way to increase the relative prices of tradable goods, should that be deemed necessary, is through the use of fiscal policy.

Growth and stabilization in the SVOE: the Barbados example

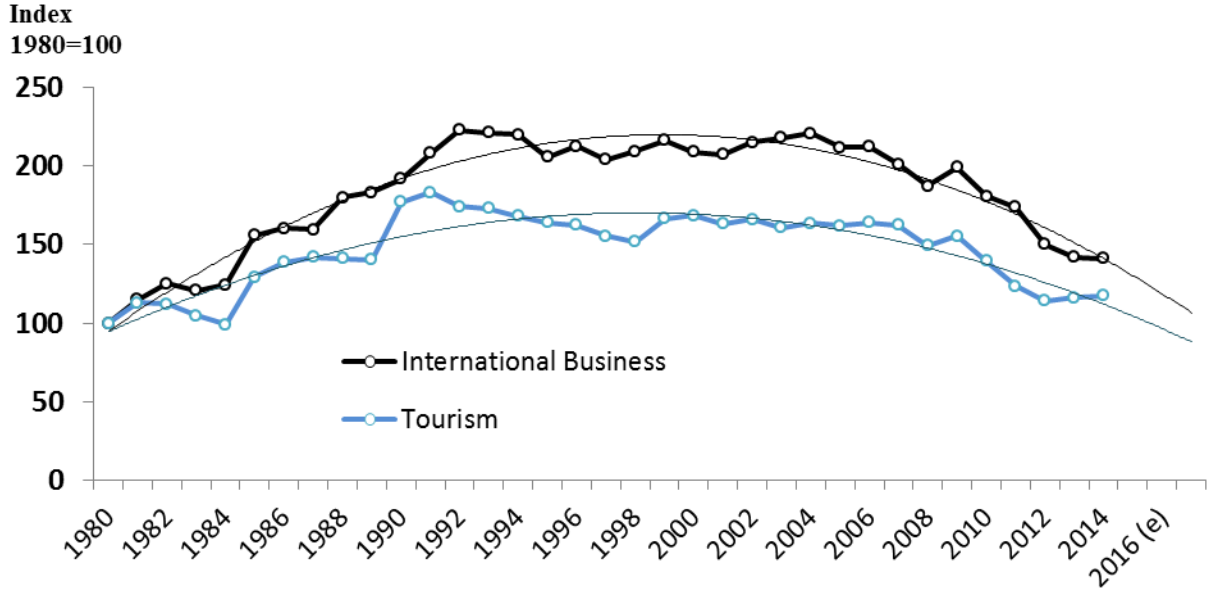
Barbados is a typical SVOE, with a marginal import propensity in the range of 70-80 percent, and with a narrow range of exportables, mainly tourism, international business services and exports of beverages. The island's economy was badly affected by the global recession in 2008, and real GDP declined by 4 percent in the next year. Tax revenue declined in subsequent years, resulting in a widening fiscal deficit, which reached a high of 11 percent in the fiscal year that began in April 2013. Widening fiscal deficits implies that the national debt and the debt servicing cost would increase. For a time the foreign exchange reserves were sustained by foreign borrowing, despite the fiscal pressure on aggregate spending and imports, but the result was a loss of the country's investment rating on international financial markets, as the debt and

¹² For example, see World Economic Forum, Global Competitiveness Report 2010–11, www.weforum.org, the 12 pillars of competitiveness.

deficits grew. That effectively meant a loss of access for market flotations, because the cost of borrowing became prohibitively high.

The Government of Barbados responded with a two-pronged strategy for growth, led by the foreign-exchange-earning sectors, and stabilisation, based on a medium term strategy for reducing the fiscal deficit. Growth resumed in 2015, after a false start in 2011, led by the tourism sector, which provides about 60 percent of the country’s foreign exchange earnings. The Barbadian tourism sector is highly competitive, ranked number seven in the Americas, after the US, Canada, Brazil, Mexico, Panama and Costa Rica,¹³ and the Barbadian tourism product is highly regarded. Barbados draws its visitors from four main regions, the UK, the US, Canada and the rest of the Caribbean, which lends resilience to the sector, except in a truly global recession such as was experienced in 2008. Accommodation in Barbados is biased towards the higher quality with greater value added locally (a segment of the market that is less sensitive to income fluctuations in the visitors’ countries of origin). In tourism, and in traded services, Barbados has maintained prices that are competitive in each segment of the market, compared to the Caribbean and Central American rivals (See Figure 2).

Figure 2: Tourism and international business services price competition



¹³ World Economic Forum, *Travel and tourism competitiveness report 2015*.

Source: Working Paper “Barbados International Competitiveness” by Dr. DeLisle Worrell & Shane Lowe, January 2014, Central Bank of Barbados

A second important source of foreign exchange earnings for Barbados is the international business and financial service sector. This accounts for about one-third of its foreign exchange earnings. Barbados’ competitiveness in this sector is based on its established reputation for transparency and a regulatory framework that is kept up to date with international guidance. Investors in the sector benefit from the country’s network of double taxation treaties and bilateral investment treaties. Barbados provides a platform for international companies to establish value added operations locally that serve to increase their competitiveness globally, creating a strong incentive for the growth of the sector. That growth has been inhibited by the so called de-risking strategies of international banks and initiatives to reduce shifting of profits among countries, which have in effect resulted in non-tariff barriers to international business in small international business centres. However, the medium term prospects for the sector are strong, based on the business proposition that underpins the profitability of doing business in Barbados.¹⁴

The third sector driving the renewal of growth in Barbados is beverage exports, particularly rum, which account for approximately 10 percent of the remaining foreign exchange earnings. Barbados claims the distinction of having been the first country to have produced rum, and Barbadian brands have established a name for themselves in North America and beyond. Once again the growth is based on the inherent appeal of the product.

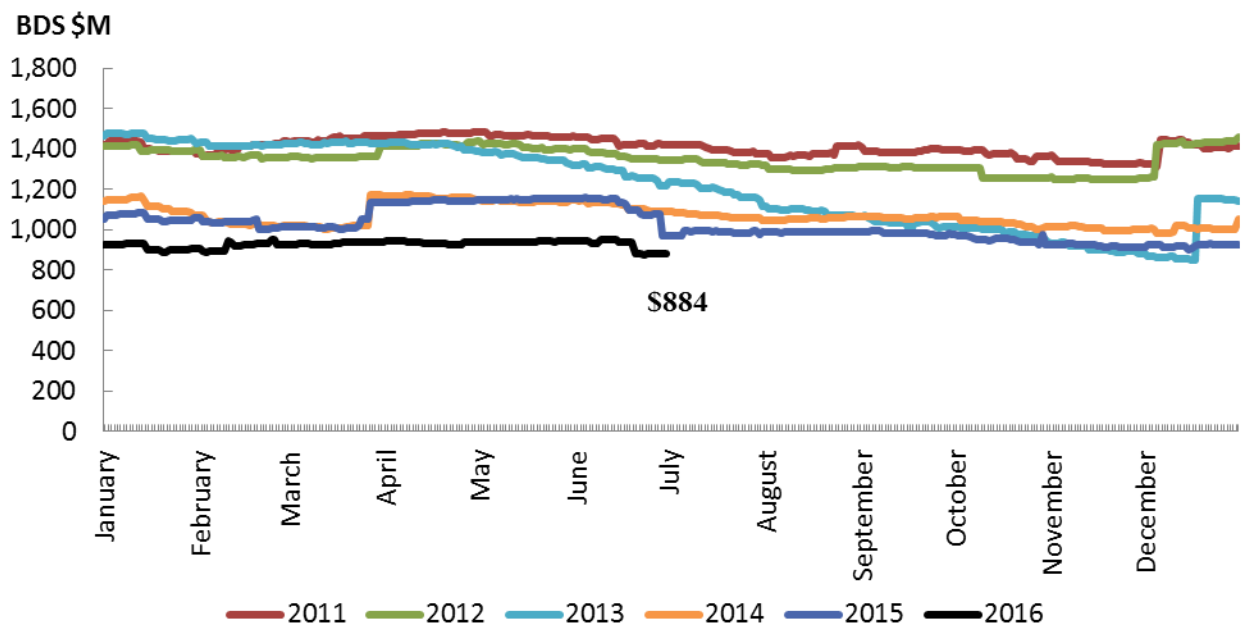
Economic growth is forecast to average about two percent per year over the next five years, driven by these export sectors. This growth is sustainable because it is based on activities in which Barbados has an established international reputation which underpins its competitiveness. These are the activities for which the Barbados brand is known and respected. Growth might be faster, by another percentage point or more, if there is a significant improvement in labour productivity, which has stagnated. In addition, the country has made an encouraging start in the direction of substituting solar and wind power for fossil fuel generation. As alternative energy production is stepped up, the significant savings in imported fuels that result would be equivalent to a new export sector, in terms of the foreign exchange saved. Achieving 100 percent generation

¹⁴ Invest Barbados, “IFCs in a borderless global economy, report on the conference in Barbados,” September 11 2014.

of power with renewable energy is many years away, and will require considerable investment, however.

The encouraging growth prospects depend on maintaining economic stability and a balance of external receipts and payments. The maintenance of Barbados' exchange rate anchor, which has remained in place since 1975, lends credibility to Government's fiscal policy, encourages domestic saving, and reduces uncertainty that might otherwise be a deterrent to investment. The Central Bank of Barbados has a robust framework for maintaining a level of foreign exchange reserves adequate to support the fixed exchange rate on the interbank market. The bank produces a daily report on its foreign exchange holdings, in the format shown in Figure 3.

Figure 3: Daily FX reserve chart to June 30

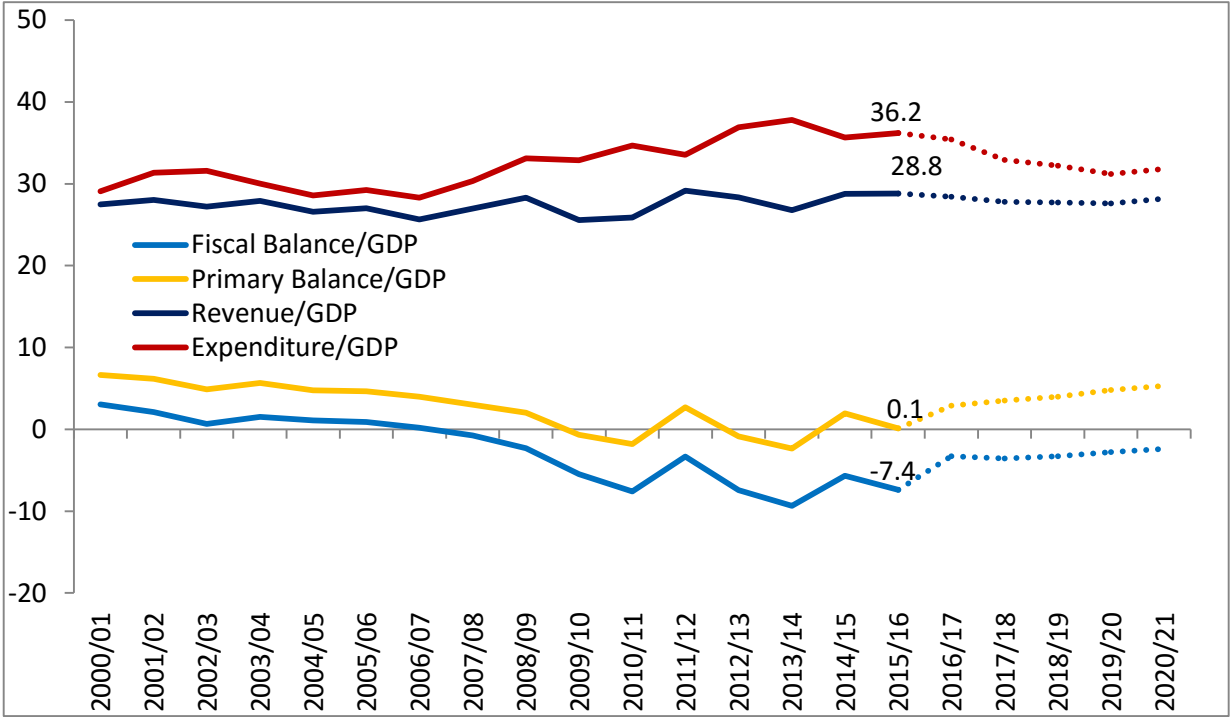


Source: Central Bank of Barbados

It is immediately obvious from Figure 3, which is a picture shared daily with the Minister of Finance and top policy officials, that the demand for foreign exchange was in excess of supply from April 2013. The Minister agreed to the Central Bank's recommendation for a fiscal contraction to arrest the slide. The first effort, in August 2013, proved inadequate, and a further adjustment was needed in December. The normal reserve pattern has re-emerged in the years since, but it has not yet been possible to restore foreign reserves to the old level, to allow fiscal

space in the event of another episode of exchange market pressure. That points to the ongoing need to reduce the fiscal deficit further. Fiscal projections for the next five years are shown in Figure 4. On the basis of this forecast, the overall debt to GDP ratio should be reduced from the current 108 percent to about 100 percent by 2020.

Figure 4: Fiscal balance to GDP



Source: Accountant General and Central Bank of Barbados

Small states are different

SVOEs are more vulnerable to external shocks than larger economies simply because the external transactions coefficients are so much larger, on both the current and the capital and financial accounts. Small states may build resilience to excess volatility, and achieve levels of economic performance comparable to larger, less vulnerable economies, but building resilience comes at a cost. These issues have been thoroughly investigated by the World Bank,

the Commonwealth Secretariat, and the University of Malta.¹⁵ SVOEs are also more limited than large economies in what they can do in response to an economic shock. There is little scope for countercyclical fiscal policy, unless it can be financed by prudent foreign borrowing, because the ensuing increase in aggregate demand generates an excess demand for foreign exchange. Further, there are no possibilities for import substitution, through an exchange rate depreciation or any other means, and no way to boost exports of goods and services through price adjustment, since their prices are governed by the international market. Therefore, in contrast to large economies and closed economies (which, if small, are at subsistence levels of living), SVOEs have no way to respond to a shock that reduces output, other than to absorb the loss of real income.

The third important distinction of SVOEs has to do with the policy framework. A market-determined exchange rate anchor has proved to be a simple, credible, and effective framework for stabilization policy that delivers what is possible (equilibrium of external payments and the avoidance of balance of payments crises) and does not pretend to deliver what is not possible (growth in the face of declining demand for exports of goods and services, or containment of imported inflation). What is more, the exchange rate anchor can be maintained in the absence of sophisticated policy frameworks, so long as fiscal policy is sufficiently prudent.

In contrast, the popular monetary and inflation targeting frameworks have proved to be problematic for SVOEs. Despite the wealth of research that has been devoted to the conventional approach, policy makers are still forced to use rules of thumb in determining the extent of monetary adjustment that is needed for achieving their targets. What is more, in SVOEs the open financial account often nullifies the thrust of monetary policy.¹⁶ The inflation targeting framework faces a credibility problem in SVOEs: “core” inflation, which is the central bank’s target, excludes food and fuel, which are imported and typically account for more than 50 percent of the consumer basket. It becomes immaterial if the central bank has achieved its target for “core” inflation, if the retail price index rises much more aggressively.

¹⁵ See Lino Briguglio, Gordon Cordina, and Ellawony Kisanga, *Building the Economic Resilience of Small States*, University of Malta and the Commonwealth Secretariat, 2006.

¹⁶ See DeLisle Worrell, “Bank Behaviour and Monetary Policy in Small Open Economies with Reference to the Caribbean,” *Social and Economic Studies*, 46 (2/3) (October): 59–74, 1997, <http://www.jstor.org/discover/10.2307/27866137?uid=2129&uid=2&uid=70&uid=4&sid=21100909212171>

Conclusion

Small very open economies are different from large economies, in that they face a foreign exchange constraint that cannot be alleviated by depreciation of the real exchange rate or other policies. This constraint affects monetary, fiscal, and exchange rate policy including fiscal sustainability, debt management, and patterns of economic growth. With respect to monetary, fiscal, and exchange rate policies, the most accessible framework for such economies is an exchange rate anchor, where the foreign currency market is balanced by managing aggregate demand, using fiscal policy. The most sensitive indicator of fiscal sustainability derives from the fiscal impact on the balance of external payments and receipts. It has also argued that expansion in the small very open economy is sustainable only if led by the sectors that earn or save foreign exchange.