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Lessons from Barbados' Experience with the International Monetary Fund

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Introduction

Severe balance of payments problems have induced many developing countries to seek the financial assistance of the International Monetary Fund (IMF). IMF resources provide liquidity which may be unavailable elsewhere in the market but, unlike commercial loans, they are often conditional[1] on the implementation of measures which are directed at removing the threat to external viability. While IMF supported adjustment programmes are intended to correct macroeconomic imbalances and lay the basis for sustainable growth, they are often politically unpopular in the Caribbean and elsewhere. Concerns have been raised about the choice of policy tools like devaluation and their impact on income distribution and on the level of economic activity (Howard (1992)). Many analysts like St. Cyr (1982) are critical of what they perceive as the single minded focus of the IMF on safeguarding a country's external solvency at the expense of economic growth and transformation.

The profound changes in the world economy over the past twenty-five years have challenged economic policymakers in very small open economies like Barbados to rethink economic strategies in order to promote sustainable long-term growth. The collapse of the Bretton Woods fixed exchange rate system and the generalized floating of international currencies, the inflationary pressures of two oil shocks, the slowdown in direct foreign investment, lower levels of concessional funding, high international interest rates and a severe debt crisis have provided a

[1]Guitian (1996) provides from an IMF perspective, the rationale for Fund conditionality.

chastening experience for many developing countries. However, in an article in which he provides quantitative support on the negative impact of external shocks on Caribbean economies, Gafar (1996) suggests that the macroeconomic problems faced by many developing countries are often attributable to a combination of external shocks and inappropriate domestic policies. In a review of the features of economies in the period immediately preceding their first IMF programme, Santaella (1996) notes that these economies are often marked by "weak balance of payments, low output growth, tough external conditions and expansive financial policies".

The combination of external shocks and weak domestic policies has forced all of the more developed economies of Caricom, with the exception of The Bahamas, to seek the assistance of the IMF in addressing their problems. Barbados' own economic circumstances have forced it to use Fund resources on three occasions, in 1977, 1982-84 and 1992-93. The character of each arrangement with the IMF varied according to the size of the problem and the policies needed to return the economy to a sustainable growth path. This paper examines and attempts to distil lessons from the Barbadian experience with these IMF arrangements. The paper pays attention to the external and internal factors which precipitated each crisis, focusing particularly on the size of the public sector imbalance. In addition, it examines the type of policies used to restore stability and how they may have differed from the pre-existing policy stance. In Section 1 we review briefly the type of arrangements which Barbados has had with the IMF, while in Section 2 we examine the factors which undermined economic stability. Section 3 examines the policy responses under these IMF programmes while in Section 4 we provide a comparison of the performance of the economy during the IMF arrangements. In Section 5 we review the lessons which can be gleaned from this experience.

1. Use of Fund Resources

Barbados became a member of the IMF on December 31, 1971. The IMF as originally conceived was intended to foster the expansion and balanced growth of world trade. International circumstances have expanded the IMF's role and it executes its mandate by serving as a forum for consultation and collaboration on international money affairs and overseeing the monetary and exchange rate policies of members so as to ensure that there is a stable environment for the world economy to grow.

Table 6.1: Barbados: Use of Fund Resources
SDR Million

	1977	1982-84	1992-93
CFF	6.5	12.6	22.2
% of quota	(50)	(49.4)	(64.5)
Stand by	---	31.9	23.9[1]
% of quota		(125)	(69.5)
Duration (months)		20	16
Total Purchases (BDS$m)	15.1	97.1	102.0

[1]Of this SDR 9.2m remained undrawn when the programme expired.
Source: International Monetary Fund

One of the central functions of the IMF is the provision of financial resources to its members to enable them to avoid or correct external payments imbalances. Since its inception in 1946, the IMF has developed a number of these financial arrangements, whose designs are differentiated by the type of problem encountered, the policy requirements, the duration and the access as a percentage of quota.[2] Barbados has availed itself of two facilities, the Compensatory Financing Facility (CFF)[3] and the Stand-by arrangement (SBA).[4]

[2]The quota is equivalent to a member's subscription and determines voting power and access to financial resources. Quotas are determined by economic size and are reviewed every five years.

[3]The CFF is intended for countries which experience a temporary shortfall in export earnings deemed to be beyond the control of the authorities. The assessment of the shortfall is based on the latest 12-month period preceding the request for drawing and estimates regarding the medium-term trend of exports. The maximum drawing under this facility of 83% of quota was revised to 65% in 1989 when a new Compensatory and Contingency Financing Facility (CCFF) was created. The Contingency aspect of the facility is intended to support countries which face external shocks during the course of adjustment programmes.

[4]The Stand-by Arrangement is the most common adjustment programme available to middle income countries. It is intended to stabilize the economy over a period of twelve to twenty four months. An essential feature of this type of arrangement is performance clauses (conditionality) and phased disbursements of financial resources.

The timing, duration and size of Barbados' drawdowns from the IMF since 1977 are set out in Table 6.1. The first drawing in 1977 was related to compensatory financing for an export shortfall and involved no conditionality, but subsequent purchases from the Fund have been accompanied by upper credit tranche[5] standby arrangements. The differences in approach reflect both the nature of the problem at the time and the degree of access to alternative financing. The 1982-83 programme was completed successfully in terms of the targets agreed between the IMF and the Barbadian authorities and all drawdowns were made. The 1992-93 programme was preceded by severe external disequilibrium, requiring a faster pace of adjustment and involving a mix of macroeconomic and structural measures. Fiscal and external equilibrium were quickly restored but slow execution of structural measures resulted in Barbados' failure to draw down fully on the resources under the standby arrangement.

2. Economic Instability

The Barbadian economy has faced several shocks over the past twenty five years, resulting in a contraction in output, high inflation and a weak external balance. The quadrupling of oil prices in 1973, the international recession and high interest rates of the early 1980s and the impact of the Gulf War in the early 1990s all had adverse effects on the economy. There were other external factors which had smaller effects to which the economy was able to adapt without undue dislocation. However, domestic influences often made the situation worse. In particular, there was a tendency for marked deterioration in the public sector deficit around the time of the election cycle, reflecting the impact of cuts in tax rates or increased expenditure on wages and public sector capital formation. This often resulted in a significant increase in lending to the public sector by the Central Bank. In most cases sharp policy reversals were required in order to restore balance in the economy.

Barbados' recourse to IMF financing reflects the impact of these pressures on the external accounts, with the rationale for intermittent drawings varying from precautionary in 1977 to the need to secure external liquidity and address fundamental disequilibrium in the economy in 1992. A synopsis of key macroeconomic indicators for the period 1975-1995 provided in Table 6.2, demonstrates the similarities in the features of the economy in the period immediately preceding the request for IMF arrangements. While there was no

[5]Stand-by Arrangements in excess of 25% of quota.

discernible pattern for inflation in the pre IMF programme, because of the strong influence of external factors on prices, the economy was already in recession at the time of the 1982 and 1992 IMF programmes. Large fiscal deficits coincided with absolute declines in excess liquidity in the financial system in 1981 and 1991 and significant interest rate hikes and increases in reserve requirements were implemented to curb the growth of private sector credit. In addition, there was intense pressure on the international reserves associated with a marked deterioration in the external current account, the result of sluggish export growth and rapidly rising imports.

While the three drawings from the IMF shared common features, the background and the magnitude of the disequilibrium varied over time. For example, the 1977 CFF drawing was a precautionary response to a decline in the import reserve cover which, already substantially lower than in the halcyon days of the 1960s, fell from almost 11 weeks in 1975 to just under 7 weeks in 1976. The economy was just emerging from the 1973 oil price shock which, along with the implementation of the Caricom Common External Tariff, created severe inflationary pressures and depressed economic activity. Favourable sugar prices in 1974, and more particularly in 1975, had attenuated foreign exchange problems for a while, but declining prices in 1976 reduced substantially domestic commodity exports at a time when tourism earnings were sluggish and imports were expanding. In light of subsequent events, it must be noted that the central government deficit for the fiscal year (FY) 1976-77, an election year, was 7.1% of GDP, worsening in FY 1977-78 to 8.0% at a time when private sector credit demand was outstripping growth in monetary liabilities. The decline in reserves and increased pressure on the Central Bank to accommodate government's financing needs were alleviated by external borrowing, enabling a gradual tightening of fiscal policy. By FY 1978-79 the fiscal deficit was cut back to 2.8% largely on the strength of revenue growth as the economy expanded.

Blackman (1979) identifies the policy mix, including a measure of voluntary wage restraint and the introduction of selective credit controls and import controls on motor vehicles, as a critical influence in protecting the balance of payments during this period and avoiding the tougher upper credit tranche programmes in which Guyana and Jamaica were already involved. However, as demonstrated later, the maintenance of external viability rests on the balance between financial discipline and a vibrant export performance. In this regard, the absence of more stringent policy measures would seem to hinge significantly on the exceptional growth in foreign exchange earnings which, together with foreign borrowing, enabled the import reserve cover to recover to just over 11 weeks in 1978.

Table 6.2: Barbados Key Economic Indicators 1975-1985

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Growth Rate(%)	(1.9)	4.4	3.6	4.9	7.9	4.4	(1.9)	(4.9)	0.5	3.6	1.1
Investment Ratio[1]	19.2	27.0	24.0	22.9	23.5	24.8	27.6	22.6	19.9	16.2	15.4
Inflation (%)	20.3	5.0	8.3	9.5	13.2	14.0	14.6	10.3	5.3	4.6	3.9
Wages (%)	9.9	9.6	20.3	10.7	7.4	20.2	10.5	11.3	5.8	9.1	4.9
Unemployment Rate(%)	22.5	15.6	15.7	13.3	13.2	14.5	10.8	13.7	15.0	17.8	18.7
Central Government Balance[1]	(3.0)	(7.1)	(8.0)	(2.8)	(3.5)	(5.4)	(8.1)	(6.0)	(3.4)	(5.2)	(5.2)
General Government Balance[1]	n.a.	n.a.	(6.3)	(0.5)	(1.4)	(3.5)	(6.3)	(3.0)	(1.0)	(3.3)	(3.9)
Public Sector Balance[1]	n.a.	n.a.	(5.8)	0.4	(1.1)	(2.7)	(5.6)	(3.4)	(1.4)	(2.7)	(4.5)
Net International Reserves ($M)	82.4	57.7	58.9	104.3	119.8	158.4	150.3	145.2	160.8	128.4	176.6
Gross Liquid Assets ($M)	82.4	57.7	74.0	119.4	134.9	162.5	166.2	141.9	140.0	130.3	130.1
Import Reserve Cover (Weeks)	10.8	6.8	7.6	11.2	9.0	9.1	8.2	7.7	6.5	6.0	6.7
External Debt Ratio[1]	5.4	5.7	7.1	14.0	12.1	12.5	18.7	22.6	24.9	29.9	37.3
Liquid Assets/Demand Liabilities (%)	107.9	76.8	82.6	110.2	93.2	100.8	93.4	7.3	72.2	63.4	57.8
External Current Account[1,2]	(10.3)	(14.7)	(10.4)	(5.7)	(5.1)	(2.0)	(12.1)	(3.3)	(3.4)	2.3	5.2
Net Domestic Assets of CBB ($M)	(6.0)	17.4	30.7	3.9	24.9	2.8	27.7	40.8	33.2	77.0	48.1
Credit to Public Sector ($M)	0.1	13.0	57.2	22.6	49.1	38.7	65.3	81.5	58.2	48.3	6.5
Monetary Liabilities (%)	15.8	9.7	10.5	23.2	23.8	17.8	10.8	5.8	7.2	7.4	6.6
Credit to Private Sector (%)	7.9	12.4	13.0	6.3	19.9	12.7	18.2	5.2	13.1	0.8	3.7
Average Loan Rate	11.3	10.3	10.0	10.0	10.1	11.0	14.0	13.5	11.9	12.0	10.9

[1] Ratios as a % of GDP at Market Prices
[2] Public and Public Guaranteed Debt
Source: Annual Statistical Digest, Central Bank of Barbados and Staff Reports, International Monetary Fund.

Table 6.2: Cont'd. Barbados Key Economic Indicators 1986-1995

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Growth Rate(%)	5.1	2.8	3.5	3.6	(3.3)	(3.9)	(5.7)	0.8	4.0	2.9
Investment Ratio[1]	16.0	16.0	17.5	19.1	18.8	17.1	9.5	12.7	13.4	13.8
Inflation (%)	1.3	3.4	4.8	6.2	3.1	6.3	6.1	1.1	0.1	1.9
Wages (%)	4.2	1.7	7.4	2.7	5.1	0.9	(1.8)	1.6	0.0	n.a.
Unemployment Rate(%)	17.8	17.9	17.2	15.4	15.0	17.3	23.0	24.3	21.9	19.4
Central Government Balance[1]	(4.6)	7.5	(3.0)	(1.9)	(7.2)	(1.4)	(1.9)	(1.9)	(1.1)	(0.8)
General Government Balance[1]	(4.3)	(6.5)	(2.1)	(1.2)	(6.6)	(1.0)	(0.6)	0.4	1.1	1.6
Public Sector Balance[1]	(5.0)	(7.3)	(3.2)	(1.4)	(7.4)	(0.8)	(0.1)	0.6	2.3	1.9
Net International Reserves ($M)	214.3	212.8	293.0	207.8	119.3	38.9	97.4	139.4	257.6	340.6
Gross Liquid Assets ($M)	166.3	152.0	257.1	185.6	89.2	68.8	181.6	151.0	252.6	309.0
Import Reserve Cover (Weeks)	8.2	8.4	12.6	7.8	3.8	2.9	10.1	7.4	11.6	11.6
External Debt Ratio[1,2]	37.1	35.1	30.6	27.5	27.1	27.1	29.9	27.0	25.5	22.3
Liquid Assets/Demand Liabilities (%)	71.3	53.9	84.5	61.6	24.4	22.8	52.3	49.4	83.8	88.6
External Current Account[1]	1.4	(1.1)	3.1	1.6	(0.5)	(1.4)	9.0	4.3	7.8	5.7
Net Domestic Assets ($M)	19.1	69.0	11.1	93.6	246.9	262.7	249.8	166.3	43.7	8.1
Credit to Public Sector ($M)	(32.6)	(21.4)	(61.7)	18.9	105.8	150.3	145.0	111.7	(8.0)	(108.0)
Monetary Liabilities (%)	8.2	12.0	14.1	2.4	15.2	(4.1)	7.2	1.1	11.3	6.3
Credit to Private Sector (%)	5.9	11.1	10.3	10.4	4.3	3.4	(1.9)	(1.1)	12.8	14.7
Average Loan Rate	10.2	10.3	11.1	12.7	12.1	15.0	12.6	11.3	11.9	11.8

[1] Ratios as a % of GDP at Market Prices
[2] Public and Public Guaranteed Debt
Source: Annual Statistical Digest, Central Bank of Barbados and Staff Reports, International Monetary Fund.

The 1982 borrowing underscored the vulnerability of the economy to external shocks and the need to maintain a sound macroeconomic framework. High commodity exports and tourism earnings in the late 1970s did not provide an adequate buffer against shocks such as those caused by the 1979 oil shock, high interest rates and recession in industrial countries. By 1980, tourist arrivals had stagnated but favourable price and output developments in the sugar industry created breathing space for the economy. However, coincident with the worsening of external conditions, fiscal discipline began to lapse. Demand for higher wages on the basis of higher inflation was accommodated as evidenced by the public sector wage settlement in the lead-up to the 1981 election which averaged 30%. Disposable incomes were also raised through lower taxation on personal income. Government accelerated its capital works programme and, as a result of higher spending and revenue loss from cuts in taxes, the overall public sector deficit more than doubled, reaching 2.7% in FY 1980/81, up from 1.1% the previous year. (Table 6.3).

The situation worsened in 1981, aggravated by early and unseasonably heavy rains which interrupted the sugar cane harvest and reduced sugar production. The depression in the tourism sector was made worse by the appreciation of the US dollar against sterling and European currencies which made Barbados and other Caribbean destinations more expensive for tourists from non-US dollar areas. Higher prices made imports dearer resulting in a weaker current account performance while unfavourable differentials between domestic and international interest rates emerged and worsened the capital account. By the middle of 1981, therefore, problems of external liquidity emerged as tight domestic liquidity conditions transferred the burden of government financing to the Central Bank. The public sector deficit for 1981-82 of 5.6% of GDP was the highest since FY 1977-78 and both the Central Bank and the government borrowed heavily to support external liquidity. The inability to recover payments for regional trade transactions under the Caricom Multilateral Clearing Facility[6] made the liquidity situation even more tenuous.

Gradually, monetary and fiscal policies were tightened also but, with the first half of 1982 yielding no improvement in reserves, government undertook its first standby programme on the strength of adjustment measures taken during the latter half of 1981 and the first half of 1982. The programme was relatively simple in structure, aimed at arresting the deterioration in the external accounts

[6]Blackman (1997) provides an informed discussion of the circumstances surrounding the collapse of the CMCF.

and reducing government's fiscal imbalance[7] from 6.6% of GDP in FY 1981- 82 to 2.3% in FY 1983 - 84 by setting limits on the net domestic assets of the Central Bank, supported by limits on public sector borrowing from the banking system and on external debt.

The 1992 programme was more complex than its predecessor. The foreign exchange deterioration was more severe and targets for the central government deficit and net international reserves formed part of the quantitative performance criteria along with limits on the net domestic assets, public sector borrowing requirements and external debt. In addition, government committed itself to a wide ranging list of structural reforms, related to tax policy, the financial sector, trade liberalization, the labour market and state ownership of commercial entities. The objectives of the programme were more demanding than that of 1982, as evidenced by the aim to cut the public sector deficit from 6.7% in FY 1990 - 91 to 0.6% in FY 1991- 92 and a revised surplus position of 1.1% by FY 1992 - 93. As described in the next section, the policy matrix required stronger action to achieve fiscal and external objectives.

The development of this disequilibrium in external and fiscal accounts is attributable to several causes. The crisis itself was preceded by strong economic growth between 1986-89, influenced in part by growth in tourism and by expansionary fiscal policies. However, efforts to broaden the economic base for foreign exchange earnings had still left the economy almost dependent on one sector - tourism and there was increasing concern that the foreign exchange earning sectors were losing competitiveness. In addition, with a fillip being provided to consumption and investment in non-traded activities, the import reserve cover was not adequate to protect the economy against external shocks created by a slowdown in economic activity in industrial countries and the impact of the Gulf War on tourist travel and unsustainable domestic policies.

The relaxation in fiscal discipline almost immediately after the 1982-84 programme provided the impetus for the unsustainability of domestic policies. The sharp reduction in direct tax rates in 1986[8] created excess liquidity as the private sector adapted to the increase in disposable income This monetary overhang was only partially addressed by the budgetary correction of FY 1988/89

[7]The data reported in Tables 6.2 and 6.3 differ from those cited by the Fund because of data revisions and slight differences in definitions. To facilitate comparison between programmes, the deficit here refers to that incurred by central government and the NIS, the deficit concept used by the Fund in the 1982 programme.

[8] For a discussion on these policies see Howard(1986).

Table 6.3: Barbados Public Sector
1979-1987

	1979	1980	1981	1982	1983	1984	1985	1986	1987
TOTAL REVENUE	28.9	28.0	27.4	29.9	30.8	30.0	31.5	29.7	29.3
Central Government	25.8	25.3	24.2	24.5	25.1	24.5	26.4	25.0	24.5
NIS	3.1	2.6	3.2	5.4	5.6	5.5	5.2	4.7	4.9
TOTAL CURRENT EXPENDITURE	22.4	21.2	22.8	24.6	24.8	26.6	28.4	26.9	27.8
Central Government	21.2	19.9	21.0	21.3	21.1	22.5	23.9	21.8	23.3
NIS	1.2	1.3	1.8	3.4	3.7	4.2.	4.5	5.0	4.5
CURRENT ACCOUNT BALANCE	6.6	6.8	4.7	5.2	6.0	3.3	3.1	2.8	1.6
NFPE[1] CURRENT ACCOUNT BALANCE	(0.7)	(1.3)	(1.0)	(0.2)	0.3	0.6	(0.5)	(0.9)	(1.4)
PUBLIC SECTOR CURRENT ACCOUNT	5.9	5.5	3.7	5.0	6.3	3.9	2.6	1.9	0.1
TOTAL CAPITAL EXPENDITURE	7.0	8.2	9.3	7.2	7.7	6.7	7.2	6.9	7.2
Central Government	4.1	6.0	7.5	4.5	5.1	4.6	4.8	5.4	6.1
NIS	0.2	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
NFPE	2.7	2.2	1.8	2.6	2.6	2.1	2.4	1.5	1.1
OVERALL BALANCE	(1.1)	(2.7)	(5.6)	(3.4)	(1.4)	(2.7)	(4.5)	(5.0)	(7.3)

[1]NFPE - Non Financial Public Enterprise
Source: Annual Statistical Digest, Central Bank of Barbados and, Staff Reports International Monetary Fund.

Table 6.3: Cont'd. Barbados Public Sector 1988-1995

	1988	1989	1990	1991	1992	1993	1994	1995
TOTAL REVENUE	32.8	32.9	32.0	34.5	38.1	37.4	38.4	38.5
Central Government	28.1	28.4	27.2	28.9	31.4	30.4	30.5	30.8
NIS	4.7	4.4	4.8	5.6	6.6	7.0	7.9	7.7
TOTAL CURRENT EXPENDITURE	27.9	27.4	30.2	30.9	33.6	32.6	33.0	32.2
Central Government	23.4	23.1	25.5	25.3	27.7	27.1	26.7	26.1
NIS	4.6	4.3	4.7	5.5	5.9	5.4	6.4	6.1
CURRENT ACCOUNT BALANCE	4.9	5.5	1.8	3.6	4.5	4.9	5.4	6.3
NFPE[1] CURRENT ACCOUNT BALANCE	(1.3)	(0.4)	(1.0)	(0.1)	(0.0)	0.1	0.7	(0.4)
PUBLIC SECTOR CURRENT ACCOUNT	3.5	5.1	0.8	3.6	4.5	5.0	6.1	5.9
TOTAL CAPITAL EXPENDITURE	6.6	6.5	8.2	4.1	3.8	4.0	3.4	4.0
Central Government	5.7	5.3	6.2	3.0	3.1	3.0	2.9	3.4
NIS	0.0	0.0	0.2	0.4	0.3	0.1	0.1	0.0
NFPE	0.9	1.2	1.8	0.7	0.4	0.9	0.4	0.5
OVERALL BALANCE	(3.2)	(1.4)	(7.4)	(0.8)	(0.1)	0.6	2.3	1.9

[1]NFPE - Non Financial Public Enterprise

Source: Annual Statistical Digest, Central Bank of Barbados and Staff Reports International Monetary Fund

and in 1989 private sector spending accelerated, resulting in an improvement in the public finances based on higher indirect taxes from a surge in imports.

Government engaged in extensive commercial borrowing between 1985-90 but, as spending picked up and external debt service ballooned in 1990, the foreign exchange reserves came under pressure. The sharp rise in government spending on wages and capital formation in the lead up to the 1991 election raised the public sector deficit for FY 1990/91 to 7.4% of GDP, comparable only to that of 1987, the first full year of the 1986 tax regime. The contraction in domestic liquidity together with the increase in public sector external debt service shifted the burden of financing government onto the Central Bank at the expense of the reserves. The liquidity situation worsened rapidly in the first half of 1991, as a loss of confidence in the exchange rate regime precipitated a crisis in the foreign exchange market.

3. Policy Response

The policy approach to the economic crises varied with the level of reserves and concerns about long-term competitiveness serving as the key influences. The fixed exchange rate served as the anchor for the economy but there were marked differences in the scope of the fiscal and monetary adjustments during the course of the stabilization process. In addition, the 1992 programme included a range of structural reforms designed to improve efficiency and enhance competitiveness.

3.1 *Exchange Rate*

The exchange rate is actively used in many IMF programmes as a policy tool. Edwards and Montiel (1989) cite certain characteristics of economies which have devalued their currencies, including expansive fiscal policies, deteriorating terms of trade, real exchange rate appreciation, depletion of foreign reserves, a weakening of the external current account and a steep increase in the parallel exchange rate. Within the Caricom area, where these signs have emerged with varying degrees of intensity, Guyana, Jamaica, and Trinidad and Tobago devalued their currencies and eventually shifted to floating exchange rate regimes. However, in Barbados, as in the Eastern Caribbean, the fixed exchange rate has been the cornerstone of economic policy. The Barbados dollar was delinked from Sterling to which it was pegged prior to 1975 and revalued against the currency of the US dollar by 9%, at a time when the United Kingdom still accounted for the largest segment of Barbadian imports. Since then successive administrations in Barbados have argued that an exchange rate fixed against the major trading

partner provides an inflationary anchor for small economies without market power, reduces uncertainty and creates an environment conducive to investment. They rebuffed critics who claimed that the exchange rate should be used to promote external competitiveness, noting that, in an economy with high levels of *de facto* wage indexation, attaining competitiveness via devaluation is not attainable. This stance by the Barbadian authorities provided scope for conflict with the IMF for, while that institution often agreed to programmes involving fixed exchange rates, there was sympathy for the view expressed by Mecagni (1995) who argued that "discrete changes in the exchange rate, while perhaps weakening the discipline value of the anchor if they occur with any frequency, may be necessary to foster adjustment in response to changed economic circumstances". Mecagni, in a review of IMF programmes over a three year period ending in mid-1991, indicates that countries with exchange rate anchors supported by strong financial adjustment tended to have lower inflation rates than countries without nominal anchors. Mecagni observed also that the fiscal adjustment and current account performance in countries with explicit anchors tended to be stronger but export volume grew more slowly, indicative of a weaker competitive position.

In 1981, when foreign exchange reserves came under pressure, debt flows and a gradual fiscal adjustment cushioned the impact of adverse developments on foreign exchange holdings and the risk to the exchange rate. The IMF estimated that the real effective exchange rate for the Barbados dollar appreciated by about 14% for the eighteen months ending June 1982, but similar appreciations in other tourism driven economies weakened the arguments for an exchange rate adjustment based on a long-term loss in competitiveness. This position was reinforced after 1985 when the appreciation was substantially reversed as the US dollar weakened against major currencies.

In 1991 the challenge to the exchange rate was more pronounced. Despite the depreciation in the real effective exchange rate, foreign reserves were under sustained pressure between 1986 and 1990. Relatively low external debt indicators facilitated an increase in foreign borrowing between 1986 and 1990, ensuring that foreign exchange was available to meet the economy's needs. However, this served to mask the problems created by fiscal pressures. The rapid deterioration in the reserves of the Central Bank during 1989 and 1990 was cushioned by new borrowings but, as foreign creditors became increasingly concerned about economic developments, access to capital markets declined. With outflows for debt service payments accelerating, the depletion of foreign exchange also signalled the loss of confidence in government's ability to maintain the official exchange rate. The gross reserves of the Central Bank fell to less than

two weeks of foreign exchange in terms of imports and banks were unable to service demand, precipitating unprecedented queues for foreign exchange. Rumours of an emerging small black market for foreign exchange surfaced, raising concern that the official exchange rate could not be sustained. These developments were consistent with the observations of Edwards and Montiel but Government maintained its resolve to keep the exchange rate unchanged. Instead, Government returned to first principles, employing a strong fiscal correction supported by wage restraint. Privatization proceeds helped to smooth the initial cash flow problems and the effective dampening of demand facilitated a swift recovery in the foreign exchange situation. This helped to allay fears, deter the growth of the black market and restore confidence in the official exchange rate.

3.2 *Fiscal Policy*

Barbados usually maintained small public sector deficits, the exceptions being for fiscal years 1976-77, 1977-78, 1981-82, 1985-86, 1986-87, 1987-88 and 1990-91. It is significant that each of these deviations from norm occurred in the year preceding, the year of or the year following an election. Premised on the notion that a fiscal stimulus will stimulate the economy by raising economic activity and increasing employment, these lapses in discipline suggest that inadequate attention was paid to short term financing constraints or long term macroeconomic implications.

While the associated external imbalances of 1976-78 and 1985-88 were financed mainly by non-conditional funds from the IMF and commercial sources, those created by the fiscal problems of 1981-82 and 1990-91 resulted in the use of conditional IMF resources. Policymakers demonstrated a preference for commercial borrowing while there was ready access, believing that in postponing the adjustment the economy would grow out of its difficulties. Boamah and Haynes (1997) indicate that the removal of institutional constraints in domestic and foreign capital markets had helped to foster fiscal indiscipline and the recourse to IMF programmes was indicative of the authorities' acceptance that the fiscal stance had become unsustainable and could jeopardize the exchange rate.

In each crisis situation the authorities were able to raise substantial external resources prior to the adjustment programmes but an essential difference in the evolution of events appears to be the earlier start to the adjustment effort in 1981 vis à vis 1991. The public sector deficit for FY 1981-82 was contained to 5.6% of GDP, and there was sufficient external liquidity to enable a more gradual adjustment than in 1991. The 1981 fiscal adjustment focussed on rolling back the increase in disposable incomes arising from wage increases and tax concessions,

and in stalling domestic demand. New payroll taxes were introduced to finance a new unemployment insurance programme, health and transport levies. In addition, taxes on fuel, alcohol and cigarettes were raised as were charges for water, postal services and public transportation in an effort to reduce transfers to public enterprises. Planned capital expenditure was also scaled back.

Given the unsustainability of the fiscal outturn for FY 1981-82, further policy adjustments were needed in each of the two following years. In fiscal year 1982/83, in anticipation of a new public sector wages settlement (which averaged 7% over two years), Government implemented further measures to strengthen public finances, including an additional 4% in payroll levies, additional taxes on fuels, alcohol and cigarettes, provision for stamp duty on imports and increased consumption tax on selected commodities. In addition, the public investment programme was further reduced.

With a slower than anticipated recovery in economic activity, new measures, including partial relief for some sectors, were introduced in FY 1983-84. These were reflected in a further increase in payroll levies which was partly offset by personal income tax relief for individuals at the bottom and top of the income tax scale. There was also an additional increase in stamp duties and higher taxes on cigarettes and gasoline. Taxes on kerosene and fuel oil fell but there were higher charges for public transportation and postal services. Public servants also received a 2.5% wage increase, supplementary to the average 7% in the preceding fiscal year.

While the 1982-84 fiscal adjustment was phased in, that of 1991 was more dramatic. The adjustment was preceded by a central government deficit of 7.2% of GDP in FY 1990-91. The large central government deficit, resulting from surging expenditures for wages, transfers and capital expenditure at a time of declining revenue, coincided with increased external debt servicing and reduced foreign exchange earnings. This placed considerable pressure on the Central Bank and its foreign exchange. In particular, ceilings on Central Bank temporary lending were breached even after a 75% increase in the statutory limit. Given the size of the fiscal imbalance and its impact on foreign reserves, restoring order to the public finances required a steep reduction in the deficit and an increase in financial savings by the private sector.

In its budget of FY 1991-92, government made a tentative start to the adjustment process by introducing a stabilization tax on personal incomes, raising consumption taxes by 2 percentage points, raising employer's contribution to the Severance payments scheme from 0.25% to 1% of wages and committing to scale back capital expenditure and keep transfers in check. However, these initiatives proved ineffective in restoring confidence and stalling the slide in reserves and in

October 1991 a more comprehensive approach aimed at reducing the imbalance in public sector finances was adopted. With a substantial deficit already incurred in the first half of the year, the degree of adjustment required a surplus for the last six months. As a result, government cut basic wages of public sector employees by 8% and trimmed about 3,000 persons from public sector payrolls. Disposable incomes were reduced, the result of an adjustment in the stabilization tax rate from 1.5% to 4% for individuals earning in excess of $15,000, increased ceilings for contributions to payroll levies and the National Insurance Fund and increased contribution rates and income ceilings for unemployment insurance. Benefits under the unemployment insurance and severance schemes were reduced while a tax was introduced to pay for the severance costs of public workers not covered by the severance scheme. The tax-free status of inputs for domestic manufacturing was phased out and a temporary payroll tax was imposed on employers to fund the gradual implementation of this measure. Tariffs and user fees on public transportation, housing, water, postal rates and natural gas were raised as were consumption taxes and taxes on petroleum, while a surcharge on luxury goods was introduced.

The goals of this stiff fiscal adjustment related to the need to reduce immediately the imbalance between demand and supply of resources so as to curb the outflow of foreign exchange, preserve the value of the exchange rate and restore confidence. By emphasising wages as part of the correction, it contributed to the need to enhance cost competitiveness in the economy. In addition, to place the fiscal accounts on a sustainable path, the adjustment sought to improve financial efficiency in the public sector. In this regard, Government identified commercial enterprises which created fiscal pressures for transfers or loan guarantees for closure or sale.[9] In addition, Government sold its shares in the telecommunications sector and in manufacturing to realize foreign exchange when reserve holdings were very low. Some public enterprises were restructured with a view to improving efficiency while greater attention was paid to cost recovery in relation to services provided by the public sector.

The central government was targetted to achieve a balanced budget in FY 1992-93, but the comprehensiveness of the 1991 adjustment made further measures unnecessary. However a gradual direct tax reform aimed at reducing the burden of payroll taxes on business and at simplifying the direct tax system came on stream in mid 1992, enabling the phasing out of all but one of the payroll levies

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[9]For example, Caricargo was closed while the Arawak Cement Plant and the Heywoods Hotel were sold.

on personal incomes and the elimination of most tax preferences. With the economy still in recession, in the absence of new fiscal measures, adjustment after FY 1991/92 took the form of expenditure restraint. Table 6.4 illustrates how the fiscal adjustment was achieved. The sharp increase in the revenue ratio in 1992 reflects the impact of higher tax rates but the share of output absorbed by current expenditures continued to rise mainly because of higher interest payments. This placed pressure on capital spending which was more than cut in half from the excessive levels of FY 1990-91.

Added to the strength of the adjustment in the 1992 programme is that fiscal discipline was maintained and strengthened in the three fiscal years immediately following the end of the programme. This reflects the combined effects of the wages freeze for most of that period and low capital spending by government. This feature of the adjustment is in marked contrast to the earlier programme when fiscal discipline was quickly eroded. Reform of the indirect tax system to achieve greater simplification and deepen trade reform was also intended as part of the restructuring, but was not implemented until the beginning of 1997.

Table 6.4. Public Sector Adjustment
% of GDP

	1981/82 - 1983/84	1990/91 - 1992/93
Revenue	3.4	6.1
Current Expenditure	-2.0	-3.4
NFPE[1]	1.3	1.0
Capital Expenditure	1.6	4.4
Net Lending	-	-0.8
Total Adjustment	4.2	7.3

[1]Non Financial Public Enterprises
Source: Central Bank of Barbados

3.3 *Monetary Policy*

In its early days the Central Bank executed policy through floors and ceilings on selected interest rates, reserve requirements, selective credit restrictions and the provision of special credits to the foreign exchange earning sectors. These policies were structured to strengthen economic activity while maintaining balance of payments stability. As evidenced by the lead-up to both the 1982 and 1991 programmes with the IMF, negative deviations from external balance were marked by a general tightening of monetary policy. However, there were critical differences in the implementation of policy during these two periods. High interest rates abroad in 1981 created an unsustainable differential between domestic and foreign rates, forcing a sharp increase in domestic rates. The Bank set the average lending rate at 15%, up from 11% in 1980, while the minimum savings rate reached 8% compared to 5% in 1980. These were complemented by hikes in the Bank's discount rate to commercial banks, reserve requirements and restrictions on credit to the personal and distributive sectors. By the time that the programme was started in October 1982, international rates were already declining and there were two interest rate declines within the first quarter of the programme. To support balance of payments objectives, the tightening of monetary policy was supported by a reinforcement of credit controls on consumer credit which were maintained into the programme period.

In contrast, while the 1992 programme was preceded by a sharp increase in interest rates, designed to slow credit demand, there was a pronounced move towards deregulation in the financial sector. The ceiling on average lending rates was lifted before the programme began and after a short period of global credit limits, aimed at bringing private sector credit in line with targets, all credit controls were discontinued in 1992. In addition, directives on the down-payment on and length of repayment period for consumer durables were eliminated as was the ceiling on the interest rate for residential mortgages. This shift in policy stance towards less intervention in the market was in keeping with the emerging line of reasoning within the Bank that selective credit controls lose their effectiveness when maintained over long periods. Evidence of this phenomenon can be found in the growth of the credit union movement outside the regulatory framework of the Bank and the development of leasing arrangements by private sector companies which effectively circumvented the Bank's regulations on consumer credit. Low cost special credits extended by the Bank to foreign exchange earning sectors were also phased out, as the Bank moved to limit money creation to public and private sectors.

The instruments of monetary policy after the implementation of the stabilization programme were markedly more limited, confined to a minimum deposit rate at banks, the discount rate and reserve requirements. The minimum deposit rate, retained in deference to the oligopolistic nature of the banking system, in conjunction with trends in the market determined treasury bill rate, serves as the signal rate for interest rate changes. Following the policy change monetary policy had to adjust to wide variations in the financial sector and the Bank has actively used its interest rate instruments to signal the need for caution. Deposit growth, particularly during the first half of the year, has accelerated reflecting improved performance of the foreign exchange earning sectors. Credit demand tended to be very strong during the second half of the year, often at a pace exceeding the authorities expectations. In particular, commercial bank lending to the personal sector has almost doubled between 1992-96, reflecting the innovation of credit cards and the removal of the distortions created by credit controls.

3.4 *Wages Policy*

Almost from its inception, the Bank articulated a case for wage restraint as part of the general policy of maintaining competitiveness and protecting the exchange rate. Backward wage indexation to consumer prices provided the basis for wage settlements, with the public sector often serving as the guide to the private sector. In a high inflation environment, these settlements proved onerous to the public sector, as indicated by the 30% public sector wages bill settlement in 1980. However, fluctuations in real wages between 1980 and 1990 left real wages for the public sector virtually unchanged[10] while real earnings of most other sectors and in particular tourism improved significantly. The increase in real wages in the manufacturing sector was uneven, but the beverage, food and chemical subsectors achieved real wage gains far in excess of the tourism sector. The ability to sustain those wage increases partly reflects the protection accorded the manufacturing sector by tariff and non-tariff restrictions.

As part of the adjustment effort, Government signalled the need for lower private sector wage settlements by limiting the 1982-84 public sector wages hike to an average 7% per annum. As indicated earlier a supplementary wage payment was made to public sector workers in FY 1983-84. The aftermath of the

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[10]These calculations omit the impact of regrading exercises which were used to correct disparities in earnings in the public and private sector.

adjustment effort was followed immediately by a relaxation of the incomes policy, as evidenced by a 15% increase in public sector wages for FY 1984-85. In contrast, the 1991 programme took a less accommodating view of the wages situation, a result of the size of the fiscal and external equilibrium and the perception that there was a need to enhance the external competitiveness. As in 1980, there was a major wage increase immediately preceding the crisis. In addition, senior public servants, whose salaries had moved out of line with the market benefitted from a regrading exercise. The policy solution was divided into two parts. First, to correct fiscal disequilibrium swiftly and dampen domestic demand public sector workers had their salaries reduced by 8% for a period of eighteen months. Secondly, to narrow the competitiveness gap Government called for a two-year national freeze of basic wages, with provision for productivity bonuses and profit sharing arrangements. The National Productivity Board was set up to help the private sector refine formulas for the measurement of labour productivity. Public sector wages were restored to their pre-October 1991 levels in April 1993 but, under a wages protocol between Government, the private sector and the unions the wages freeze was formalized and sustained until March 1995. A second two-year protocol permitting negotiated wage increases was adopted in 1995.

The cut in public sector wages was particularly unpopular, precipitating national strikes and a legal challenge to the legitimacy of the action[11]. The episode underlined the critical support which Government needs from the social partners in the execution of adjustment programmes; for whatever the technical merits of the programme it is likely to fail unless accepted by the broader community.

4. Performance and Stabilization

Stabilization programmes are aimed at correcting fiscal and external imbalances with a view to placing the economy on a sustainable growth path. How successful these programmes are is often difficult to assess because of the multiple factors which can condition your interpretation. A programme which leaves the economy on a low growth non inflationary path seems preferable to a destabilizing inflationary environment which may ultimately lead to high unemployment. In this context, while stable growth and high emplotment levels represent the long-term objectives of economic policy, it is often misleading to

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[11]The Privy Council upheld the right of Government to enact wage reductions for civil servants but public sector workers who are not paid out of the Consolidated Fund are awaiting the outcome of a separate legal challenge to the legality of the wage cut.

assess an adjustment effort in terms of its short-term impact on growth and jobs. Programmes can also be examined by comparing the actual performance with programme targets. Programme targets are of two types, i.e quantitative performance criteria and more general macroeconomic indicators. Quantitative targets impose discipline on policymakers and serve to unlock liquidity for cash strapped economies. However, while achievement of targets is considered as a precondition for restoring growth, negative small deviations from these point estimates need not undermine a programme's objectives. The Barbadian experience illustrates that satisfying performance criteria may not be compatible with short-run growth which may hinge on international conditions and the local investment climate.

While Barbados generally satisfied the quantitative performance criteria in both stabilization programmes, the following features of economic performance are worthy of note.

1. Recession turned out to be deeper than originally anticipated.

   (a) The foreign exchange sectors, particularly tourism, were adversely affected by unfavourable international developments.

   (b) Investment significantly declined under both programmes. Under the first programme investment in nominal terms declined from 1982-85 and only recovered to 1981 levels in 1988. For the second programme the decline in investment was sharper and recovery started faster, but by 1995 nominal investment had not reached 1989 levels.

2. The lost output was translated into job losses, with the second arrangement proving more costly in terms of jobs. A measure of the magnitude of output loss under the two programmes is that it took at least six years to recover to peak output levels. In the case of the 1992 programme peak 1989 output had not been achieved by 1996.

3. Inflation abated under both programmes after shocks caused by fiscal measures. This improvement reflects improving external

conditions as well as the dampening effects of wage restraint, particularly during the 1992 programme.

4. Import demand fell more than anticipated, facilitating stronger than expected reserve improvements.

5. The sharpness of the contraction in economic activity in the 1992 programme led to revenue underperformance and sharper than programmed cuts in capital expenditure. The 1982 programme maintained spending by increased taxes after the initial adjustment; capital expenditure still averaged over 7% of GDP in the 1982 programme, but it fell to only 4% between 1992-95.

6. There was a marked strengthening in non-sugar commodity exports after the 1991 programme. The decline in real wages and the effects of tax relief helped recovery of segments of the manufacturing sector. This contrasts with the experience of the first programme when weak economic conditions in Caricom depressed demand for Barbadian exports. The World Bank (1991) argued that Barbados' trade policy had an anti-export bias and advocated a regime of trade reform. This reform served as a major component of the 1992 structural adjustment. The common external tariff was reduced as part of an agreement within Caricom. Non-tariff barriers were removed and in some cases replaced with a temporary surcharge to give the domestic manufacturing sector an opportunity to adjust to the changing environment. With the initial weakness in domestic demand the thrust towards export markets strengthened as reflected in the growth of non-sugar commodity exports.

7. While it is still early, the performance of the tourism sector and foreign investment flows after 1992 seem to have provided a more sustainable basis for long-term growth and reserve accumulation. In contrast, weak investment flows contributed to excessive debt accumulation between 1985-88.

5. Lessons

Over the past twenty-five years, the Barbados economy has evolved from a dependence on agriculture to one based on foreign exchange earning services, particularly tourism. The objectives of sustained growth, high levels of unemployment and low inflation have been pursued in the context of a fixed exchange rate. Given the uneven path which the economy has travelled during this period, several observations about Barbados' experience over the past twenty five years are worth noting:

1. A fixed exchange rate is sustainable but it requires disciplined financial policies if it is to remain a credible anchor for the economy. In this regard,

   a) Fiscal policy is the cornerstone of a fixed exchange regime. It is instructive that whenever fiscal policy became lax, foreign reserves came under pressure, requiring a combination of foreign borrowing and fiscal adjustment. The imposition of stringent measures makes it clear that unsustainable expansionary fiscal policies may eventually carry considerable economic and political costs.

   b) Monetary policy must be supportive of fiscal discipline and must be in line with international norms to avoid destabilizing outflows.

2. The economy is very vulnerable to external shocks. Given the exchange rate regime, the import reserve cover is a key indicator of the threat to the exchange rate anchor and must be maintained at high levels. The experience of other countries, and in Barbados to a limited extent, demonstrates that when reserves are depleted, exchange rate speculation surfaces; reversing that development demands swift credible action by policymakers.

3. Expansionary fiscal policies, in the absence of substantial import reserve cover, are likely to aggravate the vulnerability created by external shocks. Governments need to assess carefully the medium term implications of budgetary policy. Capital programmes have recurrent costs which must be

planned for in the context of revenue expectations. Perennial increases in tax rates as a means of reducing the size of deficits result in the introduction of ad hoc measures which create fiscal distortions. The recent introduction of a value-added tax is in part a response to this development.

4. There are limits to what the state can reasonably do in modern day society. Blending the provision of social services, building infrastructure and engaging in commercial activities have tended to create problems in many economies. The thrust towards greater efficiency in the public sector through cost recovery measures, public enterprise reorganization, labour reduction and privatization represent an effort to address the difficulties posed by the need to find the expenditure mix required to strengthen economic growth and tackle problems of income distribution.

5. Sustaining competitiveness is crucial to the performance of the economy. Given the relatively high import content of domestic production, unit labour costs must be controlled. Efforts to link wages to prices especially when there is a temporary jump in the price level may jeopardize cost competitiveness as well as investment prospects. This requires paying attention to changes in wages, labour productivity and the quality of goods and services produced in the economy. Productivity is enhanced both by the adoption of new technologies and by adapting the use of labour to changing economic and technical conditions.

6. Macroeconomic adjustment should take place early, thereby reducing the severity of the problem and enabling the economy to cope in a coordinated non traumatic way. The truncation of public sector capital works programmes is evidence of the sharp adjustments which often occur.

7. Borrowing is no substitute for sound macroeconomic policies, for even if borrowing temporarily softens the adjustment, it tends to leave the underlying problems unsolved. External borrowing is useful in providing resources to complement domestic savings, but access to external funds at reasonable costs, depends on the strength of the macroeconomic framework and on the market conditions when funds are needed.

8. The Central Bank is an inappropriate source of deficit financing. When Government relies heavily on the Central Bank to finance its deficit, there have been problems of reserve losses. This situation need not arise only

when the public sector deficit is large but also when private sector demand is growing much faster than private sector foreign exchange earnings. Fiscal policy therefore needs to leave a cushion for unanticipated private sector demand so as to reduce pressure on the Central Bank.

9. Structural reforms may be a critical factor in laying the basis for long-term growth. Implementing reforms is not always easy because of technical considerations and the vested interests which may be adversely affected.

10. Successful implementation of major adjustment programmes requires the understanding and co-operation of the social partners. The prices and incomes protocols agreed upon between Government, the private sector and the labour unions between 1993 and 1997 provide compelling evidence of the benefits of collaboration. Enhanced competitiveness, increased investment, growth and employment have resulted and reinforced a tradition of economic stability. The success of this cooperation imposes on the parties a responsibility not to squander the gains from this effort.

6. Conclusion

External conditions and fiscal indiscipline have forced Barbados to support its economic programmes with Fund resources on at least three occasions in the past twenty-five years. Unlike in some other developing countries, the turnaround in performance was swift as import reserve cover was restored to adequate levels. While in the short-run output and employment were adversely affected by the type of measures implemented, it is clear that a persistence of the existing policy framework would almost certainly have resulted in an even worse situation. Inflationary expectations would have been developed owing to a pervasive parallel market for foreign exchange. Having avoided that experience, there are important lessons for Barbados and other countries to gain. While the specific policy mix may differ because of economic conditions and the degree of imbalance, small fixed rate economies like Barbados need to avoid overly expansionary financial policies and excessive external borrowing. Instead, the investment environment must be encouraged by strengthening the infrastructure and enhancing competitiveness through increased productivity.

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