
THE BARBADOS ECONOMY
ROAD TO PROSPERITY
BY DR. DELISLE WORRELL
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PREFACE

My motivation for this essay is to put the performance of the Barbados economy since 2008 into perspective, and to reassure Barbadians that prosperity will return to our country, provided that prompt, decisive and appropriate action is taken to address the obstacles that stand in the way of that goal. I will show that there is abundant evidence of dynamism and competitiveness in the Barbadian private sector, and that provides the fuel for a prosperous future for our economy.

This potential, however, is clouded over by the poor performance of critically important segments of the public sector, and the fact that Government expenditures are much higher than tax revenues can support.

Barbados has the advantage of institutions that are the envy of many countries, including our Social Partnership, arrangements for close cooperation between the economic and finance ministries and the Central Bank, and regulatory institutions of high calibre, including the Financial Services Commission, the Fair Trading Commission, the Productivity Council, and the Barbados National Standards Institute.

What is more, Barbadian policy makers have the benefit of good data and reporting systems and, since 2008 Government has had in place a home-grown strategy for growth and economic adjustment.

With the right plan, the appropriate institutions and the data needed to track progress, why has the strategy not yielded the expected results and what needs to be done to put things right? The answer to this question provides us with clues to the action that must be taken to clear the path to prosperity.

In an essay of this length it is possible only to sketch the outlines of the strategy that must be implemented, without delay, to uncover the Barbadian economy's potential. This essay will be supplemented by other publications, some technical, to be posted on my website, www.delisleworrell.com. They will include:

- A technical paper on the economic forecasts, 2017-2021;
- My calculations of the impact of the National Social Responsibility Levy;
- A paper on the potential of renewable energy;
- A note on measures of productivity; and
- Centres of excellence in the public sector.

My sincerest thanks go to my colleagues who read the draft and offered useful comments and suggestions, to Tessa Ottley, to my editorial and design collaborators of Media Support International, Roxanne Brancker, Jonathan Reid and Jody Forte and to my webmaster, Simeon Wukwai.
Their assistance is deeply appreciated. Thanks especially to Monica, for her love and unfailing support.

DeLisle Worrell
October 18, 2017

SYNOPSIS

The Barbados economy is dynamic and internationally competitive, led by a private sector that demonstrates remarkable enterprise and innovation, from our largest and most successful firms to youth entrepreneurs of outstanding promise. But our public sector is living beyond its means and its low productivity is a drag on investment. Reduced Government spending and forceful measures for public sector reform are the key to arresting foreign reserve losses and securing the exchange rate anchor. This fiscal policy will restore international market confidence in the economy, improve domestic trust in Government institutions and policy and advance the economy in the international competitiveness rankings.

The competitiveness of tourism, Barbados' main source of foreign exchange and our principal engine of growth, is attested to by no less an authority than the World Economic Forum, the organisers of the world-famous Davos Forum.
In their 2017 Travel and Tourism Report Barbados retained its Number One position among Caribbean destinations and in the last three years the island has regained its share of the regional tourist market.

The economy is fueled by foreign exchange: to grow the economy we must invest to create more capacity to earn foreign exchange and to become more productive. Growth must, however, be set on a stable foundation where spending on imports is fully covered by foreign currency inflows. The persistent decline in the foreign reserves of the Central Bank, which has seen the stock fall by 50 per cent since the beginning of 2013, must be reversed.

The Global Economic Recession of 2008 caused a collapse of financial inflows for the purchase of real estate, and a stagnation in tourist arrivals. The consequences were declining foreign exchange reserves and large and persistent increases in borrowing by Government to cover operating costs. Since 2008 the Government has failed in attempts to eliminate the operating deficit. The resulting rise in debt levels has contributed to the erosion of Government's credit worthiness, at home and abroad.

THE REAL ROOT OF THE PROBLEM

The need to eliminate Government's current account deficit, and to arrest the persistent slide in foreign reserves, were the motivation for the May 2017 Budget measures. However, the Budget failed to address the real root of the problem, which is overstaffing and low productivity in the public sector. Instead, the focus was on increasing the burden of taxation which is likely to drive the economy into recession. There is an alternative fiscal programme which restores Government savings on the current account, stabilizes and reduces the debt to GDP ratio, removes the fetters on private investment and entrepreneurship and clears the path for renewed growth that is both robust and sustained. The main elements of that strategy are:

- A public sector reform package, to be implemented over three years, to eliminate Government's operating deficit and to achieve measurable improvements in public sector productivity;
- As part of that package, job cuts of about 1 500 per year in the public service over three years, with separation packages

to be funded by seeking financial support from international financial institutions;

- A cut in transfers to state-owned enterprises of 10 per cent per year over three years;
- An aggressive programme of divestment of carefully selected public assets;
- Temporary freezing of all public works, except those funded by foreign finance;
- Final approval and start of major works on all tourism projects envisioned for 2017;
- Undertaking negotiations with the IMF, IDB, CDB and other official and international institutions for financial support for a five year programme of structural adjustment, the centerpiece of which would be conditionalities on the implementation of fiscal reform.

The immediate implementation of this strategy would be sufficient to:

- Accelerate the growth rate to a sustainable three per cent per year by 2021;
- Restore foreign reserves to January 2013 levels by the end of 2018;
- Stabilise debt-to-GDP ratios and put them on a downward trajectory; and
- Improve Barbados' international competitiveness and creditworthiness.

The projected improvements in growth, foreign reserves, government interest payments and fiscal balances are shown in Figures 1 and 2.

Figure 1. Growth and Foreign Reserve Cover, 2004 – 2021

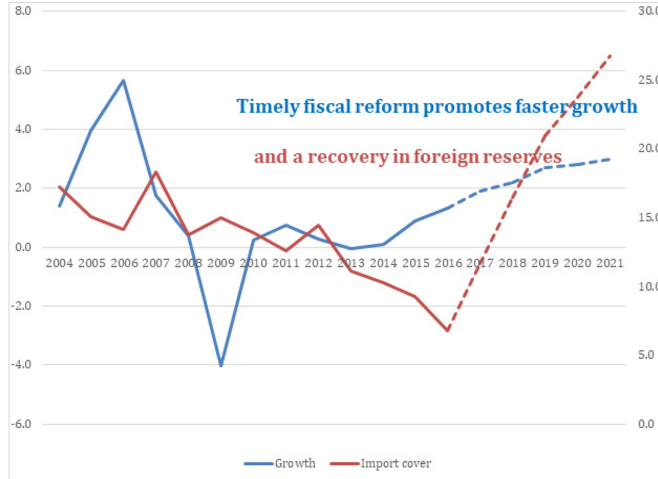
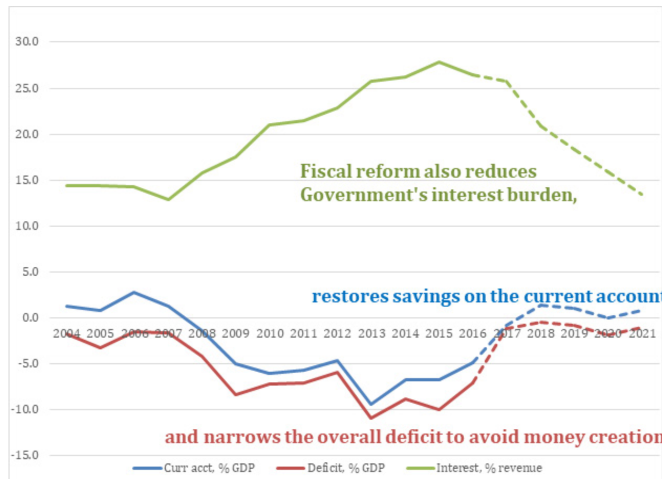


Figure 2. Interest expenditures and fiscal balances, 2004-2021



BACKGROUND

A few weeks ago I was visited by a London-based investment manager who knows Barbados well and visits periodically. He remarked to me that on his arrival the island seemed as prosperous as ever, contrary to his expectations, and there was little evidence of the economic malaise which has damaged Government's creditworthiness and eroded investor confidence. This is a common observation; the hardships people experience are real, but they are not a fatal blow to their lifestyles or aspirations. The IMF has had Barbados on crisis watch for five years or more and ratings agencies have downgraded the country's credit precipitously, but so far there has been little impact on the standard of living.

Barbados remains a modern, internationally competitive and relatively prosperous economy. Our population enjoys educational, health and other social services that are the equal of those in advanced economies. The island boasts a good infrastructure, reliable public utilities, modern telecommunications, and convenient global connectivity. Barbadians have leveraged the island's natural beauty, geographical location and ideal climate to create a highly regarded tourist industry and our human resource and skills base have allowed us to carve profitable niches in international business and financial services and manufacturing.

As was inevitable, the economy was adversely affected by the global economic recession of 2008. Foreign investment inflows fell sharply, tourist arrivals declined, the economy contracted in 2009 and Government tax revenues fell, causing a large deficit to emerge. However, the impact was much less severe than on previous occasions as in the early 1980s and 1990s. What is

more, Barbados has sophisticated institutions to facilitate the design and implementation of economic policies to respond to changing external circumstances. They include the Social Partnership, a monthly meeting of all top economic policy officials and financial reporting systems for Government and state owned enterprises.

With this framework in place, it should have been possible to respond appropriately to the external challenge, as Barbados had done on previous occasions. A medium-term strategy for adjustment and growth was prepared, and Government committed to policies to reduce an unsustainable fiscal deficit. Government spending was adding too much to the spending of the private sector. As a result, the cost of the imports needed to satisfy both Government and private buyers exceeded the inflows of foreign exchange. Government should have cut back to restore the balance, but this did not happen.
This essay attempts to understand why policies that would have restored the balance of foreign currency inflows and outflows were not implemented, even though such policies were publicly announced and widely discussed.

In January of 2016 it was decided at top policy levels that a final determined push had to be made to implement the main elements of the adjustment and growth strategy, but that effort produced no result. By the end of that year foreign reserves were well below the market minimum, equivalent to 12 weeks of imports.

This is the context that informed the draconian budget measures of May 2017. Government needed to balance its day-to-day spending and its tax revenues. There was no appetite for reduction in spending, so a substantial additional tax effort would be required, to add to the already high burden of taxation. This essay will evaluate the probable effects of the Budget.

The underlying competitive strengths of the economy, and the drive and inventiveness of our people are a secure foundation for the future prosperity of our economy. This essay concludes with an outline of a strategy for the reform of the public sector which will release the fetters on economic growth and equip our country with public services that we can afford and that are comparable in efficiency to those in advanced economies.

HOW THE BARBADOS ECONOMY WORKS

All economic activity in Barbados depends on a supply of foreign currency: the country needs imports to re-stock when consumer goods are sold; fuel for transportation, lighting, air conditioning and other electric and power supplies; and raw materials for manufacturing, agriculture and construction.

The foreign exchange earned from tourism, services sold overseas and exports of manufactured products is converted to Barbados dollars and spent on wages, tax payments and purchases of household goods and services. The production of these services and the delivery of services is what adds value to our economy and grows the Gross Domestic Product (GDP).

That added-value generates an additional demand for imports.

The domestic economy is stable and sustainable when foreign currency inflows are sufficient to fully satisfy the demand for imports. That does not mean that foreign earnings have to match imports; the country can afford to borrow abroad to supplement foreign earnings and grow the economy, provided the borrowed funds are used to increase the capacity to produce, through investment in infrastructure, machinery,

equipment and new technologies.

However, it is the case that the total inflow of foreign currency, from earnings, investment by foreigners and borrowing from foreign sources, must be sufficient to fully accommodate the demand for imports.

In order to grow the economy, the country must earn or borrow more foreign currency to afford the extra imports that a growing economy needs. For that, the country must invest to boost capacity to produce more goods and services at competitive prices, and introduce new organisational structures and new technologies that will enhance worker productivity.

Foreign borrowing for these investment purposes is good debt, because it creates a tangible, lasting benefit in the form of additional capacity to produce and add value to the economy.

The key elements of good economic management in Barbados are therefore:

- to balance inflows and outflows of foreign currency to keep the economy stable; and
- to invest in new capacity to produce, in infrastructure and in the adoption of new technologies and new ways of working that raise national productivity and enhance the profitability of investment in Barbados.

It is important to balance inflows and outflows of foreign exchange because that is how we maintain an adequate store of foreign reserves at the Central Bank of Barbados and maintain the value of the Barbados dollar in terms of the US dollar. The importance of maintaining the peg is obvious: Barbadians are paid wages in Barbados dollars, but, as we have just seen, the products and services we need are sourced abroad, directly or indirectly. Therefore, any depreciation in the US dollar value of Barbados dollar means an increase in the price of imported goods and immediately makes Barbadians worse off.

The Central Bank of Barbados maintains the value of the Barbados dollar by offering US dollars at the 2:1 exchange rate (minus a small commission) to commercial banks who do not have sufficient foreign currency available to them to meet their clients' needs on a timely basis.

The Central Bank keeps a store of foreign reserves for this purpose, which it aims to keep at a level sufficient to meet any potential requirement from commercial banks needing to accommodate importers and other clients. To be on the safe side, the Bank uses a rule of thumb which requires action to maintain sufficient foreign reserves to pay for a minimum of 12 weeks' worth of imports.

Commercial banks resort to the Central Bank whenever the foreign currency they receive is insufficient to meet their customers' needs. If the overall import requirement is in excess of foreign inflows, all banks will find themselves in this situation and there will be persistent calls on the Central Bank.

As a result, the Central Bank's foreign reserves may be depleted below the minimum that the Bank needs to maintain to cover possible contingencies. This situation is avoided if government takes measures to ensure that import demand does not run ahead of the availability of foreign exchange.

The Central Bank of Barbados has developed a powerful tool for detecting the need to rebalance the supply and demand for foreign currency. Figure 3 is the daily foreign reserves monitor which the Bank prepares and circulates to top officials at the end of every business day.

It provides early warning of the emergence of foreign exchange shortages among commercial banks as occurred in 2013. A continuing fall in foreign reserve levels indicates that import demand is too high in relation to the supply of foreign exchange. In such circumstances, Government must institute measures that reduce national disposable income in order to reduce the demand for imports. It may be possible to increase the supply of foreign exchange, but that will take a year or more, by which time foreign reserves may have fallen to critical levels.

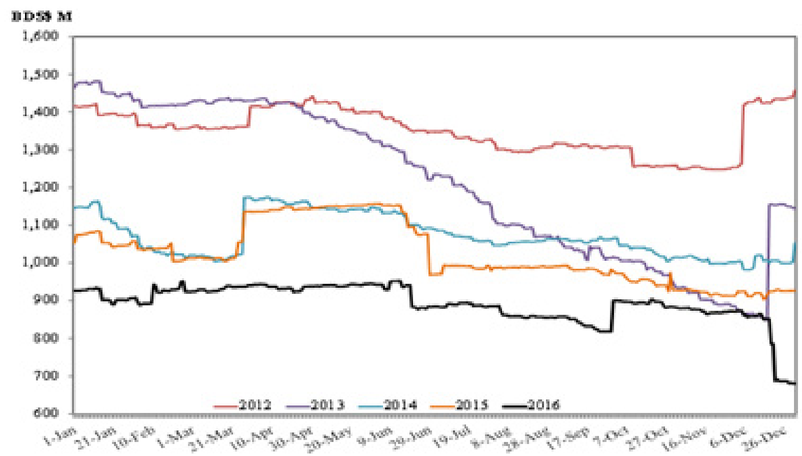
In the immediate circumstance, the focus must be on reducing imports sufficiently to restore balance. The only effective policy to this end is to cut disposable income; import rationing is impractical and merely diverts demand to the informal market,

where the value of the local currency rapidly falls.

A persistent decline in the Central Bank's foreign reserves such as was seen in 2013 signals the need for additional taxation to reduce disposable incomes, and/or a reduction in Government spending. Together the measures taken should be sufficient to reduce imports by an amount that brings the demand for foreign currency back in line with the supply.

Fiscal measures do not have instantaneous effects. As was the case in 2013, the Central Bank used up a considerable portion of its foreign reserves to satisfy the excess demand for imports before the effects of the fiscal measures kicked in. The prudent course after a foreign reserve loss of this magnitude is to sustain prudent fiscal policy for some time, even after foreign currency supplies start to increase, so that the Central Bank can restore foreign reserves to levels prior to the episode.

Figure 3. Foreign Reserves of the Central Bank of Barbados, Daily



THE ECONOMY SINCE 2008

In the mid years of the first decade of the 21st century, the economy was growing at an annual average of 5.5 per cent, thanks to a competitive tourism offering and a very highly regarded international business and financial services sector. The Central Bank's foreign reserves were on the increase, largely due to a surge in foreign direct investment, much of it for the purchase by foreigners of second homes in Barbados.

Foreign reserves in 2007 were sufficient to cover average imports for as much as 30 weeks. Fiscal policy was characterised by admirable prudence, with overall deficits between 2 and 3.3 per cent of GDP, and savings on the Government's current operations ranging between 0.8 and 2.8 per cent of GDP.

The principal impact of the Global Recession of 2008 was the collapse of demand for second homes in Barbados by UK residents, an outgrowth of the bust in the property market in the UK. Foreign direct investment in Barbados fell from over $1 billion a year between 2006 and 2008, to half that amount in 2009 and subsequent years.

The impact of the Global Recession on tourist arrivals was modest by comparison. In the 2008/2009 high season tourist arrival numbers dipped across the Caribbean, but by 2010 arrivals were once more on the increase throughout the region. Barbados shared in that revival, even though arrival numbers faltered temporarily in 2012/2013.

The decline in foreign investment was reflected in a fall in corporation tax receipts, loss of foreign exchange reserves, and a collapse of the previously vibrant construction industry. The knock-on effects of the stagnation in tourism between 2009 and 2013, and the slump in construction further depressed corporation tax receipts and in addition, reduced revenues from VAT and property taxes. Receipts from import taxes levelled out.

SAVINGS WIPED OUT!

The fall in tax receipts wiped out Government's savings on current operations, and operational costs continued to outpace Government revenues. Government froze expenditure (apart from price increases) on wages, purchases and transfers to state-owned enterprises. However, these measures proved insufficient to contain the fiscal deficit on the current account.

The deficit remained in the region of $600 million, or seven per cent of GDP. Spending restraints were relaxed in 2013, an election year and the current account deficit reached $1 billion in that year.

In the immediate aftermath of the Global Recession, Government developed a medium-term strategy to stimulate growth, while at the same time returning the Government's finances to a sustainable path. In late 2009 a high level economic committee was established, chaired by Prime Minister David Thompson, to oversee the design and implementation of economic policy in Barbados.

This committee, chaired by the Minister of Finance and comprising top officials of the Ministries of Finance and Economic Affairs, the Barbados Revenue Authority and the Central Bank, meets monthly (and more frequently when the situation warrants) to take the pulse of the economy and make any changes to keep on target to attain the objectives of growth and economic stability.

Some progress was made towards the targets of the medium-term strategy in the years 2010, 2011 and 2012. Growth inched forward at an average of 0.5 per cent a year, and the overall fiscal deficit was reduced somewhat. However, Government's operating expenses still exceeded Government revenue by the equivalent of 4.7 per cent of GDP in 2012, suggesting that the adjustment and growth strategy was seriously off-target.

The Government's international credit was rated investment grade in 2012, and Government was able to borrow US$200 million on the international market, at an affordable interest rate. Government's stated intention was to use the proceeds to support investment in infrastructure projects, but because of overspending on current operations, much of this funding was used to fund wages, purchases and transfers. Spending on infrastructure in the 2010-2012 period averaged only $112 million per year, and the slow implementation of major projects was already a cause for concern.

The medium term strategy for fiscal consolidation was thrown decisively off course by the election in 2013, which saw a ten per cent increase in Government's already excessive spending, leading to a deficit equivalent to 11 per cent of GDP, a level not seen in Barbados for many years.

The cumulative impact of Government's dis-saving over several years, aggravated by the widening of the deficit in 2013, led to shortage of foreign currency at commercial banks, a shortage which became acute from April of that year.

From the beginning of April 2013, the Central Bank was called upon continuously to sell to banks and importers from its reserves, and the foreign reserve stocks fell by 22 per cent during the course of the year (See Figure 3, earlier).

Thanks to the daily reports to top officials, reproduced in Figure 3, the Minister of Finance and members of the economic policy group saw the falling reserves scenario unfold in real time. The Cabinet was informed, a national consultation was convened in June 2013 and national Budget measures were introduced in August of that year to raise additional revenue and reduce expenditures.

When the August measures proved insufficient to arrest the slide in reserves, a second Budget was introduced in December, which did the trick.

Alongside the Budgetary measures, a revised programme for medium-term adjustment and growth was developed. The complete economic strategy package was intended to:

- eliminate the current account deficit and reduce Government's overall deficit to a sustainable level in five years' time;
- increase public sector productivity through re-organisation, with a smaller, more highly skilled workforce and improved use of technology;
- accelerate investment in tourism and infrastructure, financed largely by private foreign direct investment and borrowing from official institutions.

It was envisaged that this programme would have restored foreign reserves to 2012 levels, reduced the overall fiscal deficit to less than two per cent of GDP, and raised the growth rate of GDP to about 2.5 per cent by the end of the period.

WHAT WENT WRONG?

Government failed to implement the organisational changes in the public sector that would have led to increased productivity, a reduction in the wages bill and significant reductions in transfers to state-owned enterprises. Instead, expenditures on wages, purchases and transfers were frozen, resulting in low morale in the public service, neglected maintenance and the accumulation of arrears by Government and state-owned enterprises.

The burden of adjustment to reduce the fiscal deficit and slow the accumulation of debt was placed mainly on additional taxation. The ratio of Government revenue to GDP rose to a historic high of 29 per cent in 2016. Even so, expenditures on Government current operations remained in excess of receipts, by almost five per cent of GDP.

Failure to address low productivity in the public service has halted private investment and eroded Barbados' international competitiveness.

Several projects in tourism, construction and the energy sectors have been delayed, in some cases by years and other projects appear to have been abandoned. In every one of these cases investors have identified profitable ventures which they are able to finance and execute without official support, but they have been unable to secure timely permissions of one kind or another from official institutions.

Not included in this list are large projects such as the Andrews Sugar Factory and the waste-to-energy plant which depended on a Government guarantee. Serious doubts remain about the commercial viability of those projects.

Levels of public sector productivity that are low by international standards have also eroded Barbados' international competitiveness ranking, as reported in the World Economic Forum's Global Competitiveness Report 2017. Barbados remains the highest ranked of four Caribbean countries listed in the report, but it has slipped badly in the rankings. The reasons for the decline are:

- the large budget deficit and the rising debt levels;
- the increasing burden of Government regulation, and the growing inefficiency of the legal system;
- wasteful spending by Government; and
- concern about possible bias in decisions of Government and officials.

Government's failure to implement its own strategy meant that deficits continued to be unsustainably large and the ratio of debt-to-GDP continued to rise. The 2013 adjustment was sufficient to arrest the precipitate fall in foreign reserves witnessed in that year, but the Central Bank continued to lose foreign reserves in subsequent years, when the Bank should have been accumulating reserves to repair the losses of 2013.

To make matters worse, the combination of poor indicators - high debt, large deficit, falling foreign reserves, slow economic growth, and delayed investment - eroded investor confidence, which was reflected in the loss of investment grade for Barbados' debt, followed by a series of further downgrades and a persistent negative outlook for the future of the economy.

With the loss of investment grade Barbados effectively lost access to international financial markets. Barbados bond issues are small by international standards and are of interest generally only to investors who buy investment grade securities with a good interest rate when they are first issued, and hold them to maturity.

The downgrade of Government securities aggravated Government's financing problems. Commercial banks and private domestic investors were increasingly reluctant to lend to Government, even though there has never been a late payment on any Government obligation, much less any impairment of the principal amount invested. Investors' reluctance shifted the burden of financing Government onto the Central Bank of Barbados.

The Bank recycled some surplus funds that commercial banks deposited with Central Bank, but these were insufficient and Central Bank created new money to the extent of 3.5 per cent of GDP for Government finance in 2015 and again in 2016.

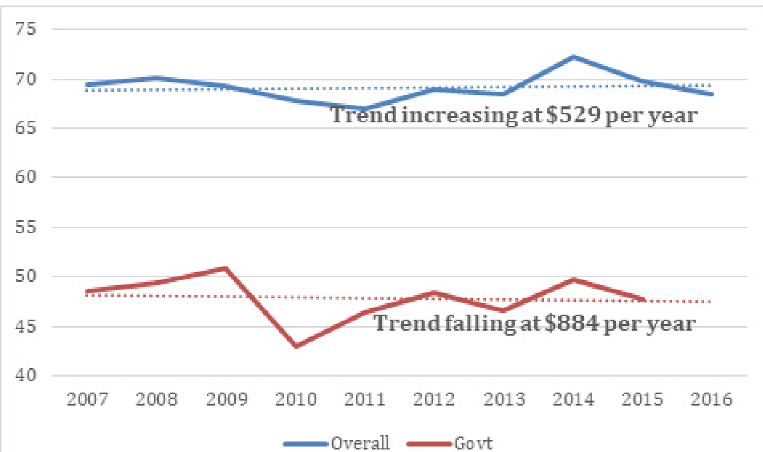
This monetary injection, in Barbados dollars, ultimately led to a demand for more imports, which had to be paid for in foreign currency. Central Bank funding of Government's deficit was the main factor behind the decline in foreign reserves in 2014, 2015 and 2016.

Declining productivity in the public sector was a drag on the recovery of the economy. The economic revival is led by tourism, a sector in which Barbados is internationally very competitive. Arrival numbers recovered in 2010 and 2011, along with the rest of the Caribbean, but faltered in the next three years, while Caribbean growth gathered pace. The year 2015 proved to be pivotal for Barbados' tourism, with a 14 per cent increase in arrivals, an all-time high for a single year. Increases have continued to outpace the rest of the Caribbean, at about half the record 2015 rate.

The revival is attributable to private investment in hotels, upgrades, refurbishment and the development of support

and ancillary services.
Apart from an extension of berthing facilities for cruise ships at the Bridgetown port, none of Government's tourism or related projects was brought to fruition. To the contrary, several tourism projects, including two large hotels, are delayed in Government administrative or legal processes of one kind or another.
There has been a downward trend in public sector productivity over the past decade, which has lowered the average for the economy as a whole (See Figure 4).

Figure 4. Output per worker, thousands of 2010 dollars



RENEWABLE ENERGY – KEY TO FASTER GROWTH

Government has also failed to develop a consistent strategy to promote the development of renewable energy. It is now known that with available, affordable and proven technology, Barbados can provide 100 per cent of its energy needs from solar, wind and other renewable sources.
Achieving this objective would be tantamount to an economic transformation for the island, providing a permanent foreign exchange windfall equal to about 25 per cent of current foreign earnings. That is the value of fuel imports which would no longer be needed.
With this extra foreign currency Barbadians could boost both consumption and investment, thereby enjoying higher living standards and boosting the country's capacity to produce goods and services.
With this goal within reach, the country deserves a single-minded strategy to accelerate the adoption of solar and wind power, which are at the heart of the 100 per cent solution. Instead, Government policy has been patchy, inconsistent and bedevilled by wrong turns. Examples include a delay of more than a decade in the wind farm at Lamberts, taxes on electric cars which make their prices uncompetitive, indecisiveness on waste-to-energy policy, and a lack of interest in public service vehicles powered by electricity.
Altogether, Government's failure to implement its own strategy for medium-term adjustment and growth has depressed growth rates since 2013 and severely inhibited investment that might have provided faster growth in years to come.

THE CURRENT ECONOMIC CRISIS

In January 2016 it was apparent that determined efforts were necessary to put Government's medium-term strategy back on track and restore the Government's credibility. Growth in 2015 had been sluggish and foreign reserves had fallen in 2014 and 2015 to a level that was uncomfortably close to the accepted minimum, an amount sufficient to finance 12 weeks of imports.

Barbadians and international investors alike were expressing concern about Government's "implementation deficit", the large number of announced programmes and projects which were stuck for inordinate lengths of time in administrative or regulatory processes. The delayed projects included high-profile private sector investments awaiting regulatory approval and two offers of privatisation that were stuck in Government's decision-making processes.

Efforts to eliminate arrears of income tax and VAT refunds had been unsuccessful and Government continued to be chronically short of cash.

The Central Bank of Barbados had been buying Treasury Bills at auction at reduced interest rates since April 2015, with a view to lowering the high premium Government was incurring over the US Treasury Bill rate.

The Bank deliberately made offers for large proportions of each Treasury Bill issue at lower interest in the expectation that the commercial banks with the highest bids would be disappointed and the average interest rate would fall.

Unfortunately, the Treasury was always short of cash, so they never rejected any offer, even those that were costly.

What was more, banks, mutual funds, insurance companies and others had become very apprehensive because of the downgrades of Government credit. Investors were increasingly unwilling to lend to Government, at any interest rate, however high.

The size of the fiscal deficit to be financed, the arrears outstanding, the delays in the implementation of funded projects and agreed privatisations, together with Government's worsening credit rating, all conspired to frustrate monetary policy. Before each Treasury Bill issue, when the Central Bank assessed Government's financing needs and compared them with the expected offers from banks and other financial firms, there was invariably insufficient funding on offer to meet Government's needs.

The Central Bank was obliged to make up the difference, however reluctantly, to avoid a further build-up of arrears by Government. This led to an injection of new money into the national expenditure stream, unless commercial banks had placed additional deposits with Central Bank in the meanwhile.

There were two objectives of Central Bank policy: to avoid money creation and to reduce Government's interest costs. The Bank has a sophisticated framework for assessing Government's financing needs and anticipating the availability of funding from banks, insurance companies and other investors in Government paper.

The Bank also has the tools needed to implement its policy, through strategic intervention in the Treasury Bill auction and the publication of an indicative yield curve for the guidance of the market. However, the success of the Bank's policy depends on the Government's achievement of a sustainable fiscal deficit that can be fully funded without money creation by the Central Bank. By December 2015 it was clear that this condition had not been met.

Faced with these circumstances, in January 2016 the Minister of Finance convened a meeting of top officials of the Ministries of Finance and Economic Affairs and the Central Bank, together with private investors, Government advisors and officials from state owned entities with a view to advancing the investment projects which were stuck in Government's pipeline.

It was envisaged that the downward trend in foreign reserves would be reversed by removing roadblocks to the early implementation of projects, together with tax measures and expenditure controls to close the fiscal deficit and eliminate the need for money creation by the Central Bank. The target for foreign reserves in December 2016 was a minimum of $1 billion.

Sadly, none of the projects discussed at the January 2016 meeting was brought to fruition by December and as a result at least $250 million of expected foreign investment inflows did not materialise. What is more, tax receipts and other Government revenues fell short of target, and Government's cash shortage persisted. Instead of the expected turnaround in the foreign reserves trend, Government and Central Bank officials tracked a steady decline in the second half of 2016, as the foreign currency market tightened.

Two factors aggravated pressure on the foreign reserves: the fact that the fiscal deficit was larger than targetted and the repayment of a foreign loan in December. Barbados Government debt had been downgraded so severely by ratings agencies since the foreign loan was contracted, that investors were not willing to reinvest. As a result, the Central Bank had to repay and replace the foreign financing with its own credit to Government, thereby adding to the money supply in Barbados dollars.

In all, Central Bank money creation in 2016 was equivalent to 3.9 per cent of GDP. Actual foreign reserves at December 2016 were more than $300 million below the target at $681 million, equivalent to only ten weeks of imports. Authorities at the Central Bank and the economic and finance ministries watched this crisis unfold over the course of the year, without being able to do anything about it.

In the absence of the investment stimulus that had been expected from the delayed projects, economic growth in 2016 was below expectations, at 1.6 per cent. With the fiscal indicators worsening and the continuing foreign reserve loss, Government debt was further downgraded by credit ratings agencies early in 2017.

THE MAY 2017 BUDGET

As Government approached the debate on the Estimates of Expenditure and Revenue for 2017/18, it was faced with a dilemma: money creation to fund the fiscal deficit had depressed foreign reserves to worrying levels, which argued for a reduction in the fiscal deficit; however, with an election in the offing, the administration wanted to increase Government spending and allow for new hires. In the Approved Estimates, expenditure on wages and salaries has increased by 8.4 per cent. That would have increased the overall deficit by a percentage point, to seven per cent of GDP.

External funding sources are virtually all closed because of Government's poor credit rating, and the policy decision not to seek financial support from the IMF.

In the absence of IMF support for the fiscal programme, access to support from other international financial institutions and official sources is very limited. The loss of confidence by banks, mutual funds and other domestic investors means there is not much support to be had from that quarter. It follows that financing a deficit of this magnitude would have fallen on the Central Bank and the resultant money creation would have reduced foreign reserves to unacceptably low levels.

There was no way out of this dilemma, other than a significant increase in the tax burden on the economy.

Unfortunately, the budgetary measures announced in May are harmful to the economy, and are unlikely to serve the intended purpose:

- The measures will probably not realise the full amount estimated and therefore money creation will continue, foreign reserves can be expected to fall further, and debt levels will continue to rise.
- The economic impact of such a large increase in the tax

burden will be severe. A contraction of real output may be expected in 2017 as a result.

- The National Social Responsibility Levy (NSRL) and foreign exchange fee are at best a temporary stop-gap; when they are removed the underlying deficit will re-emerge and will have to be addressed.
- Increasing taxes without addressing low and falling productivity in the public sector transfers resources from the more productive private sector to the less productive public sector, exactly the opposite of what is required for the competitiveness and growth of the economy.

My estimate of the maximum yield from the NSRL and the foreign exchange fee is about $330 million, taking into account the fact that the new taxes will cause a rise in prices which will reduce the purchasing power of national incomes.

This will result in a reduction of spending on consumer durables such as motor cars, and of other discretionary items. Some investment may also be postponed. Taking account of these effects reduces the expected yield from the new taxes.

My estimated yield of the taxes, which is about 3.5 per cent of GDP, is a considerable loss of the disposable income of taxpayers, and it will impact businesses in the retail sector and those who provide personal and business services. The overall impact on the economy could be to cause a contraction of overall output of three percent in 2017. There would be a further loss of foreign reserves in 2017, of about $36 million.

The revenue measures are the core of the Budget. There are no specifics about measures to be undertaken to secure the projected $82 million of expenditure cuts, and the Treasury in the past has not been able to enforce spending limits to ensure compliance. The reductions in interest payments to Central Bank have no effect on the fiscal deficit, because they reduce the Central Bank's surplus, which is paid into the Treasury. The reduction in interest payment to the NIS has a similar effect, except that the loss to the NIS will have to be made good in the future.

THE ROAD TO PROSPERITY

Thanks to the competitiveness of tourism, supplemented by export services and manufacturing, the economy has an underlying dynamic that is driving its growth, with spinoffs to distribution, business and other services. However, the economy's full growth potential is being stifled by regulatory delays on major investment, the worsening creditworthiness of Government, the lack of credibility of Government policy, and inordinate delays affecting government projects.

The underlying growth rate, based on the economy's competitive drivers, is estimated at almost one per cent for 2017 and 2018. Tourist arrivals in Barbados have been growing at about seven per cent over the past two winter seasons, and that rate is expected to continue for this year and next.

After that, capacity limits will start to kick in, a reflection of the delays in new investment, and the sector will slow down. Export services and manufacturing, which together contribute about one third of foreign currency earnings, are projected to grow on trend.

However, in this scenario the fiscal deficit remains too large and foreign reserves would fall by another $100 million in 2017. The public sector remains a drag on the economy, with declining productivity and with the factors that hurt Barbados' international competitiveness remaining unresolved. The momentum provided by tourism and other foreign exchange sectors peters out after two years, and the economy stagnates thereafter.

The key to unlocking the Barbadian economy's underlying potential is a reform of Barbados' public sector that:

- Restores the competence and efficiency of Barbados' once admirable public policy institutions, including the Social Partnership; reinvigorates established mechanisms for cooperation between Government and the Central Bank in the design, implementation, monitoring and adjustment of economic policy; and institutes timely reporting of data and performance analysis by all Government entities;
- Improves the productivity of public sector workers by providing the sector with new leadership, modern forms of organisation, appropriate skills and effective use of new technology; and
- Reduces the size of the public sector sufficiently to attain an ongoing surplus on Government's operations, so that these savings can contribute to the maintenance and upgrade of public infrastructure and the purchase of modern equipment.

What follows is the outline of a programme of fiscal adjustment and public sector reform that would satisfy the above requirements. The programme, to eliminate Government's operating deficit and achieve measurable improvement in public service productivity, would be for three years, and would consist of:

- A jobs cut of 1,500 persons each year for three years, funded by a separation package for which Government would seek external financing;
- A 10 percent cut in the value of transfers to state owned corporations each year for three years;
- A major initiative for divestment, including long term leases of the port, the airport and Harrison's Cave, in addition to the divestment already announced;
- A freeze on all public works, except those funded by foreign finance;
- Approaching the IMF for financial support by way of a five year structural adjustment programme, with conditionalities related to measurable targets for public sector reform. Fund support would unlock finance from other international financial institutions and official sources.

ELEMENTS OF THE STRATEGY

The objective of public sector reform would be to increase productivity and improve the overall competitiveness of the economy. New leadership w`ith a practical knowledge of the workings of efficient public services in advanced economies would have to be recruited for Government departments and state-owned enterprises.

Performance indicators could be drawn from the Global Competitiveness Report, the World Bank's Doing Business Report, and the work of our own Barbados Productivity Council. These could provide performance markers that could be incorporated into the conditions for disbursing quarterly tranches of finance from international financial institutions.

A separation package for public sector workers whose jobs become redundant or who volunteer for the package would not be prohibitively expensive. A rough estimate of the cost of packages, based on two years of annual salary, amounts to $90 million a year, for 1 500 workers. This would provide the average worker with a lump sum of $60 000. Government might seek funding from international financial institutions in the amount of $270 million for a programme spread over three years.

Reforms for state-owned enterprises should include the appointment of independent Boards of Directors with a clear mandate to operate within the limits of the financing allocated to them. Timely reporting should be made a condition of disbursement of transfers to these enterprises. Treasury controls should be beefed up and made effective, and operational and financial reports of Government departments and state corporations should be published on time and distributed widely.

ECONOMIC PERFORMANCE UNDER THE NEW STRATEGY

The proposed strategy would clear a path to economic prosperity, widen Barbados' regional lead in the international competitiveness rankings and restore the Government's reputation for prudent fiscal management.

The economic growth rate would be boosted to 1.9 per cent in the first year, rising to three per cent in Year 5. The pace of national productivity increase would accelerate as a result of public sector reform, contributing 0.8 percentage points per year to the growth rate.

The reform programme would produce a swift recovery in foreign reserves, to almost 12 weeks by the end of the first year, and rising to 27 weeks by the end of the fifth year. The improvement results from the absence of money creation, improved national competitiveness as a result of public sector reform, accelerated investment inflows with the return of confidence, and financial support from international financial institutions.

The fiscal accounts would be returned to sustainability, which would be evidenced by a small current account surplus, averaging a little less than one per cent of GDP, from Year 2 to Year 5.

The overall fiscal deficit would be somewhat above one per cent and could be easily financed by private investors. Government interest payments could be reduced to 13 per cent of revenue by 2021, through Central Bank intervention on the Treasury

Bill market. Government debt to the private sector would be stabilised, as a ratio to GDP.

Monetary policy would be effective in support of this strategy. The elimination of chronic cash shortages on the part of Government opens the way for the Central Bank to intervene to reduce Treasury Bill rates and to guide interest rates down all along the yield curve. The interest savings would be considerable by the end of five years.

Interest rates may be expected to fall, even as US rates increase, because the country premium on Barbados debt will fall, thanks to the fiscal correction. A credible fiscal adjustment programme, supported by international financial institutions, will draw investors back into the bond market.

CONCLUDING REMARKS

All the elements are in place for sustainable growth of the economy and the future prosperity of Barbadians, with the sole exception of the performance of the public sector, where the average productivity is one third less than the national average. Tourism, the main engine of the economy, has recovered strongly, international business is holding its own, the production of renewable energy shows immense promise, and a spirit of enterprise is abroad. The prompt implementation of a decisive public sector reform programme clears the path to sustained improvements in Barbados' still enviable standard of living.

Such a programme need not be socially disruptive, or damaging to individual livelihoods, if the reform is adequately funded, as suggested in this paper. The results of fiscal reform will begin to appear very soon and the reform would set off a virtuous cycle of returning confidence, improved creditworthiness and enhancement of the Barbadian brand.

We may draw reassurance from the recent experiences of Ireland, Iceland, Latvia and Cyprus, all small countries that recently undertook IMF-supported programmes that involved significant cutbacks in expenditure.

In similar fashion, firm measures taken immediately on the fiscal front here in Barbados could restore growth and healthy economic indicators in three to five years' time and open the path to a longer term future of exciting promise.

Notes

Dr DeLisle Worrell

is a member of the Bretton Woods Committee and the immediate past Governor of the Central Bank of Barbados. He was the Bank's founding Research Director and subsequently served as Deputy Governor. Between 1998 and 2008, Dr. Worrell worked with the International Monetary Fund and more recently, he served as the Executive Director of the Caribbean Centre for Money and Finance (CCMF). He has had research fellowships at Princeton University, Yale University, the Peterson Institute, the Smithsonian Institution in Washington DC, the Federal Reserve and the University of the West Indies. Dr Worrell holds a Ph D in economics from McGill University, Montreal.

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