



Savings and Investment in Barbados by Steven Emtage

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SAVINGS AND INVESTMENT IN BARBADOS

Introduction

"Financing Development in the Caribbean", the theme of the Seminar, covers a wide range of issues which are reflected in the subject matter of the papers being presented. In a sense, this paper considers many of these issues from the perspective of a single country - Barbados. Inevitably, however, constraints of time and space make it impracticable to cover in depth at the country level the range of issues which will be addressed in the wider regional context.

The focus of the paper, then is essentially the structure and development of the capital market in Barbados in the 1980's. The objective is to identify constraints on the efficient functioning of the market with regard both to the supply of and demand for loanable funds and to suggest any mechanisms which might address and overcome these constraints in order to improve allocative efficiency and raise the level of domestic investment. The approach will be pragmatic rather than theoretical, and as would be expected in a case study of a small open economy, domestic issues are considered against a regional and international background.

In conventional national income terminology, savings always equal investment deriving of course from the accounting identities $Y = C + S$ and $0 = C + I$, with savings being that part of income not spent on goods and services used for current consumption and investment that part of output devoted to projects providing goods not intended for immediate consumption. In an open economy, part of domestic investment may be financed by foreign savings or domestic savings may finance external investment. The relationship between domestic and foreign savings, and investment, is expressed

in the savings-investment approach to the balance of payments. This approach to balance of payments equilibrium concentrates on the Keynesian relationship between savings and investment to explain the position of the current account of the balance of payments, for the differences between the exports of goods and services and the imports of goods and services is the counterpart of the difference between aggregate domestic savings and aggregate domestic investment.

While in an ex-post fashion, the resource gap represented by the difference between exports and imports represents the part of domestic investment financed by foreign savings, it is still meaningful to speak of a savings and foreign exchange gap where the rate of domestic savings or level of imports are less than that required to sustain a given target rate of growth of output. In such situations, the lack of realised savings and available foreign exchange constitutes constraints on the attainment of the desired or required rate of growth.

Clearly, then, the act of the individual refraining from current consumption is not synonymous with savings in the economists' sense. Through financial intermediation income not consumed by one household may be used for consumption purposes by another.

Much of these financial savings will of necessity be used through the activities of financial intermediaries to satisfy the legitimate consumption needs of the country. Concrete evidence, however, supports the thesis that those countries which have devoted a high proportion of output to investment are also the countries which have the most impressive growth performances. What is involved in this process of course is not only replacing existing assets but more importantly adding to the stock of new income - generating assets and ensuring that assets so replaced and installed are used efficiently.

To the extent it is recognised that in the long run it is important to raise and sustain the ratio of Investment to G.D.P. at a level consistent with the achievement of income and employment goals and that an increasing proportion of that investment should be financed by domestic savings, then the quantum and distribution of such savings become a matter of considerable significance. This is the subject matter of this paper which is divided into three parts. Part I reviews recent developments of the Barbados economy, particularly trends in Gross Fixed Investment and its financing. Part II looks at the functioning of the local capital market and Part III considers some suggestions for reform and improvement.

I - Recent Economic Developments

In the two decades prior to the onset of the severe recession of the early 1980's, the Barbados economy experienced sustained real growth of between 3% - 5% per year. Against a largely favourable international economic background, the economy expanded and became more diversified.

The world economy in the 1960's was characterised by low inflation, monetary and exchange rate stability and continuous growth in trade in goods and services. The resulting rise in incomes in the developed countries coupled with marked reduction in the real cost of travel led both to buoyant commodity prices and rapid growth of foreign travel expenditure. Barbados was well placed to take advantage of this favourable climate. With a well developed social and economic infrastructure and political stability the economy responded to the external stimulus as well as to domestic policies aimed at promoting diversification and growth.

During the 1970's of course there were major shocks to the international economy with the escalation of oil prices and of inflation generally, and increased volatility in the capital and foreign exchange markets. These developments all had their adverse impact on Barbados but there were compensations - for example the rise of oil and commodity prices led to the rapid growth of intra-regional trade from which Barbados benefitted greatly. So that the 1970's, like the 1960's, were on the whole a period of economic expansion for the island.

The major structural change in these two decades was of course the relative decline of the importance of the agricultural sector and the increased contribution of manufacturing and services, particularly tourism, to total output.

Within the agricultural sector real value added in the sugar industry remained largely unchanged while there was a general increase of non-sugar agricultural output. The manufacturing sector initially responded to rising domestic incomes by exploiting opportunities for import substitution. Later, in the 1970's, with the advent of Caricom and the impact of rising oil prices on the economy of Trinidad and Tobago, Barbados' manufacturers were able to gain a significant share of the regional market. Simultaneously there developed an enclave sector importing components principally from North America and re-exporting finished product under preferential tariff arrangements. In all this, Barbados was aided by the adoption of outward looking policies which ensured that a competitive framework was maintained.

Mirroring these changes in economic structure were parallel changes in the structure of the labour force with an increasing proportion of workers employed in the tertiary sector - commerce, tourism and public services. In some sectors - manufacturing - while the relative proportion employed did not

change significantly, there were marked increases in productivity. Overall, despite increases in participation rates and in the labour force, unemployment fell progressively to about 10% in 1980. This growth in the employed labour force and increase in productivity was the result of strong growth in export demand accompanied by a high level of capital formation and maintenance of international competitiveness in the pricing of factors of production and finished goods.

In the period under review capital formation remained high at between 20% - 30% of G.D.P. While foreign investment increased significantly, by the late 1970's domestic savings (which reached as high as 19% of G.D.P. in 1980) was financing the greater part of this relatively high Gross Fixed Investment. Indeed by 1980, Barbados' rate of domestic savings and investment compared favourably with the fastest growing developing countries. Steady economic growth and the diversification of the economy provided emerging opportunities for private sector investment which accounted for some 80% of total capital formation. Apart from the growth of export demand, the fact that Barbados' cost of production remained competitive was a critical factor in ensuring the profitability of investment.

In the 1960's public sector savings contributed significantly to public sector capital expenditure financing on average 40% of the total. External borrowing was limited and local borrowing and statutory funds financed the balance. During the 1970's as current and capital expenditure rose, surpluses on current account diminished, and increasing reliance was placed on foreign borrowing mainly from multilateral financial institutions to finance investment. With the establishment of the Central Bank in 1973 recourse was also had to the domestic banking system for credit. However fiscal policy was able to adjust to exogenous shocks and contain the overall deficit to manageable proportions.

With strong export growth, adequate domestic savings and fiscal stability the ratio of public external debt to G.D.P. and the public sector debt service ratio increased slowly, reaching only 14% and 2% respectively by 1980. The balance of payments came under pressure in the 1970's as a result of the escalation of oil prices but corrective policies applied succeeded in making the required adjustment without recourse to excessive foreign borrowing.

By comparison with the progressive growth and development of the economy in the 1960's and (despite the energy crisis) the 1970's, in the period since 1981 the economy has faltered and a number of severe structural imbalances have emerged. The international economic environment has not been favourable. The early part of the present decade saw the industrialised countries plunged into the worse recession since the Second World War. Even though by the mid-1980's the recession had been overcome, certain features of the international economy continued to provide an unsettling framework for domestic economic policy. Volatility in exchange rates, decline in transfer of resources, falling commodity prices, increased protectionism and continuing high real interest rates have created serious problems for economies like Barbados, and these have been exacerbated by certain developments and inappropriate policy responses in the domestic economy.

Real output declined by nearly 7% in real terms between 1981 and 1982. Output in all the productive sectors declined as a result of the impact of the recession on external demand. Simultaneously with the fall in real output, the government was pursuing expansionary fiscal policies, with the public sector forced to borrow heavily from the banking system to finance its deficits. With inflation running at double digit levels and the balance of

payments under pressure, government decided to implement a stabilization programme with help of the IMF. As a result, the public sector deficit was significantly reduced, price rises moderated and the deterioration in the balance of payments arrested. Positive growth has been recorded in the past four years although it is sobering to reflect that real output only surpassed its 1980 level in 1986.

Generally, growth has been strongest in the non-traded goods sectors - distribution, transport and storage, utilities, business and general services. Value added in Tourism has only now regained the 1980 level and manufacturing has not yet found markets to replace those lost in Caricom and the enclave sectors. While non-sugar agriculture has continued to show encouraging growth, the combined effects of reduced acreage and depressed prices have resulted in large losses in the sugar industry and the need to provide public subsidisation.

Accompanying the decline and stagnation in real output has been a significant drop in the ratio of investment to G.D.P. From an average of 24% of G.D.P. in the period 1976-80, Grossed Fixed Capital Formation slumped to an average of 16% of G.D.P. in the period 1983-87 or by 30%. Assuming no change in the proportion of investment going to maintenance and creation of new fixed assets respectively or in the Incremental Capital Output ratio, this fall in the level of investment if prolonged would have a depressing effect on the long-term growth potential of the economy. While public sector capital formation declined initially as government sought to correct fiscal imbalances by cutting capital expenditure, the major decline was in the level of private sector capital formation from a high of 22% of G.D.P. in 1981 to 11% in 1986.

This trend reflected largely a decline in the inflow of foreign savings, as domestic savings, although fluctuating, remained in the range of 14% - 16% of G.D.P. in the period following 1981. External savings, which in the mid-1970's had financed as much as 70% - 75% of GDCF in some years, steadily declined as a source of financing. In the period 1984 - 86, external savings actually became negative as reduced inflows of direct investment were accompanied by rising outflows to pay dividends as well as service large foreign loans contracted by the public utilities etc. in the last decade. The sharp fall in private investment was reflected in the external current account balance which became positive after 1984 as imports of capital goods fell significantly. In the absence of a high level of investment and of a satisfactory growth rate this positive external balance emerged at the cost of the under-utilization of the country's productive potential.

The trend of a declining ratio of GDCF to GDP and a reversal of private capital inflows is not of course unique to Barbados, but is the rule rather than the exception in Latin America and the Caribbean. In the case of most heavily indebted countries this largely reflects the crippling debt service payments and the virtual cessation of new commercial lendings. In the case of Barbados, while external debt service payments, particularly for privately contracted portfolio investment, have risen, the decline in GDCF represents as well a relatively sudden and significant fall in private foreign investment.

While there has been a noticeable decline in direct foreign investment in the developing countries in general, some countries have been able to continue to attract such investment. There are many factors which influence the flow of foreign investment - political stability, regulatory and tax framework, level of social and economic infrastructure etc. - but predominant

among these is the scope for making a profit. Available data would seem to indicate that during the first half of the 1980's at least, Barbados' international competitiveness as a location for export activities declined. Wage increases ran ahead of both the rate of inflation and growth of real output in the traded goods sector. Coupled with a fixed exchange rate and tied to a currency which up to 1986 was escalating, the movement of wages relative to prices and production would have reduced Barbados' competitive position vis-a-vis that of its trading partners. More recently, as the rate of nominal wage increases has moderated and there has been renewed growth, the increase of unit labour costs has moderated. Barbados remains, however, in comparison with its Caricom neighbours and other potential competitors, a high cost producer.

The combination of sluggish growth and declining investment has resulted in a significant rise in the rate of unemployment. While the number of jobs has expanded, the parallel growth of the labour force has matched the jobs created so that the unemployment rate has remained in the 16% - 18% range. Following the stabilization programme introduced in 1982/83, there has been a steady deterioration in the public finances. While efforts have been made to increase revenue, efforts to control expenditure growth have been less successful. Capital expenditure and net lending have increased steadily while current expenditure, driven by wage increases and expansion of public sector employment has increased significantly in real terms since 1980. As a result, the overall public sector deficit has risen to between 5% - 7% of GDP for the past three years. While in the earlier years, a significant part of the deficit was financed from external sources, this consisted largely of project financing from Multilateral and Bilateral Agencies. As the size of

the deficits increased, however, government was forced to rely increasingly on domestic finance - the banking system and the surplus of the National Insurance Fund - and since 1985 mainly on commercial borrowing in the foreign capital markets.

An inevitable consequence of a slow growth economy combined with expansionary fiscal policies has been a weakening balance of payments situation. With weak export performance, rising debt service payments and the sustaining effect of increased disposable income (caused by a shift from direct to indirect taxation) on imports, government has had to rely on its commercial borrowings to shore up the reserves. The changed maturity structure of the debt caused by a shift from institutional to market borrowing has also resulted in higher interest charges. Total debt service payments now amount to some 25% of the export of goods and services. With 2/3 of the Central Bank reserves sterilised in the Caricom Multilateral Clearing Facility, the import cover of the country's foreign reserves remain uncomfortable.

The challenge facing the country is to restart export led growth at a level which will induce the flow of savings and investment required to progressively reduce unemployment.¹ Experience suggests that it is the increase in exports which is the casual factor not the increase in investment which only comes after. Assuming that the export demand exists, the question of ensuring that funds are available to create the necessary physical assets becomes the main concern.

II - Mobilization and Allocation of Domestic Savings

In analyzing the process by which financial savings are transformed into domestic investment, it is useful to distinguish a number of related but fairly distinct mechanisms. The major mechanism is the accumulation of monetary assets by surplus sectors - households and institutions - and the allocation by various intermediaries of these funds to spending units which thereby create physical assets. Then there is self-financed investment effectuated by the corporate sector out of its own savings. And finally the process of direct investment of the household, corporate or public sector in new or ongoing enterprises in the (mostly) private sector, through the Securities Exchange. These will be discussed in turn.

First, however, it is instructive to look at the macro-economic framework in which savings are mobilised and utilized. As was pointed out earlier, what is of critical importance in the process of raising the level of domestic fixed investment and the proportion financed by domestic as opposed to foreign savings, is the extent to which monetary assets accumulated in financial institutions are transformed into credit for physical capital stock. A review of the the data reveal that as in other countries at a similar stage of development, the level and growth of financial savings is determined mainly by the level and growth of nominal GDP, although there are others influential factors such as the distribution of incomes.

Macro-economic policies, however, can affect the rate at which such financial savings are transformed into physical assets by influencing the share of real credit allocated to public and private consumption, the main mechanisms being the size of the public sector deficit and the impact of

changes in fiscal policy on the distribution incomes and the incentive to accumulate monetary assets or to consume income.

The size of the public sector deficit and how it is financed is important because of its potential impact on the level of private sector investment. Whether the public sector deficit is caused by public sector consumption or investment, the possibility exists that credit allocated to its financing may hold down or depress private investment - the so-called crowding out effect. It is argued that in such a situation, by repressing private investment, 'crowding out' reduces the rate at which the stock of productive capital grows and thereby tends to reduce the rate at which productivity, per capita income, and total output grows.² Additionally, of course the persistence of deficits of the order of 5% - 7% of GDP, in the absence of an adequate savings rate, can lead inexorably, through their effects on the size of the debt and the interest burden to progressively higher and unsustainable debt/GDP ratios.

In this general context, one unfortunate effect of the current foreign exchange crisis in the developing countries is to obscure the potentially adverse impact on the growth of income and employment of large and persistent reliance on domestic debt to finance the deficit. Because servicing domestic debt does not involve any direct transfer of foreign currency, it is considered as merely shuffling paper between domestic units, which though affecting income distribution has no significant consequences for the real economy. This may be a short-sighted and misguided view. Bourne, in noting that government domestic debt finance makes great demands on private financial surpluses in many of the region's economies, states that this raises several important issues and that "there is some basis for concluding that there is considerable scope for improving the favourable influence of government expenditure on national economic development."³

Initial reaction to analyses of available data does not lend weight to

the view that there has been any 'crowding out' of private sector investment in the period under review. While there has been a significant expansion of domestic credit to the public sector in absolute terms, the share of such credit going to this sector has shown no substantial increase. Net domestic credit from the Banking system to government expanded in the mid-seventies with the initial ability of the Central Bank to accommodate government's overdraft requirements, but after rising to about 25%-30% of the total in the period 1976-78, it has since fallen and has fluctuated between 22%-24% for the past 4-5 years. Similarly, the share of the total assets of the consolidated financial sector held by government, after rising from 9% to 18% between 1970 and 1975, has remained constant around 20% since. In a similar vein, in the past few years, particularly in the period since 1985, excess liquidity in the banking system has been quite marked with banks holding as much as 27% in excess of their required holdings of stipulated government securities, at a time when the average Treasury Bill rate was less than half the prime bank rate.

It can therefore be safely stated that 'crowding-out' of the private sector has not been a contributory factor to the dramatic fall in the ratio of Gross Domestic Capital Formation to Gross Output in the period since 1983. With excess liquidity in the banking system, the cause would have to be found either in institutional deficiencies in transforming financial assets into physical assets or in a lack of effective demand for bankable projects.

This current situation does, however, mask a potential long-run problem for the economy. Should the coalescence of the right external environment with the appropriate mix of domestic policies lead to a return to strong export-led growth and demand for domestic credit, the size of the domestic debt and the level of debt service payments could present a problem and act as a break on

increased investment. Between 1980 and 1986, the domestic debt/GDP ratio rose by 50% to 30%, while interest and amortization payment rose from 14%-20% of current revenue. Unless the public-sector deficit can be reduced to more manageable levels of around 2%-3% of GDP, there is the possibility that the need to borrow just to maintain the level of debt service payments would act as a constraint on future growth.

The propensity of the household and corporate sectors to accumulate monetary assets - which are what Bourne describes as the "conduit" for investment⁴ - can be significantly influenced by the incentives and disincentives built into the tax system. At one extreme, it is said that the Japanese policy of offering tax-free savings accounts at the windows of twenty-two thousand post office branches (the Marayu) was a powerful factor in raising and sustaining the household savings rate to 17% of GDP. At the other extreme it is argued that the taxation of interest on savings and the write-off allowed on hire-purchase and other consumption expenses in the US has contributed to the fact that household savings rate there has fallen as low as 4% of GDP.⁵

In the case of Barbados while changes in the tax regime over the years have provided both incentives and disincentives to savings, there appears to be no consistent policy of encouraging savings as tax policy has been altered to suit the short-run needs of the Government's budget. This is not to deny that there are a wide array of incentives in the tax system but to point out that some of these incentives have been subjected to arbitrary and sometimes irrational change.

Incentives undoubtedly influence the form in which real or financial assets are accumulated. Relief on the payment of mortgage interest and for repairs and maintenance have certainly encouraged house ownership, although

there have been frequent changes in the quantum of relief in response to the financing needs of the government. Savings through insurance is also encouraged through tax relief on premiums, although the experiences of Canada (where there has never been relief) and the U.K. (where relief was withdrawn) suggest that people will buy insurance with or without incentives. Other incentives can have perverse effects - for example, deposits in Credit Unions are offered special relief but ironically, a major part of these deposits finance consumption expenditure.

In order to promote the growth of share ownership and encourage equity financing, successive governments have introduced concessions aimed at reducing the transactions cost of holding shares and in effect subsidising share purchase. Thus, what was in fact but not in name a capital gains tax on the appreciated value of shares was abolished and new share purchase and the issuance of bonus shares made tax exempt. These incentives have made share purchase an attractive alternative to other forms of asset accumulation but institutional and other factors have restricted the availability of shares for purchase. The inconsistency of public policy is once more shown by the fact that at the same time share ownership was being encouraged, the tax relief previously given on dividends through the dividend credit was progressively being reduced.

Government has also sought to use tax incentives in a selective manner to finance its own operations or to fund the lending activities of its own financial institutions. Thus, interest on national savings bonds and on certain debentures are tax free up to different limits. Where, as in the past few years, these funds are used to finance non-capital expenditure, the ultimate effect is merely to increase public consumption and build up future

claims on government revenue. Interest on certain other types of development bonds raised to finance long-term lending or house construction is also partially tax exempt as is interest on savings deposits at the publicly owned National Bank.

The ultimate effect of these various incentives on the volume of financial savings is not easy to quantify. There is no doubt that changes in existing or introduction of new incentives affect the allocation of savings between various instruments and intermediaries. Similarly, changes in interest rate differentials have demonstrably altered the distribution of savings between demand, savings and time deposits. Of more significance would appear to be changes in macro-economic policy affecting the level of disposable income. For example, between 1978 and 1984, total deposits of the financial sector grew at roughly the same rate as nominal GDP. In 1985 and 1986, however, total deposits grew at a faster rate, moving from 58% of GDP to 66%. This increase in the rate of growth of total deposits coincided with the intensification of the shift in the tax burden from direct to indirect taxation, which increased disposable incomes significantly.

The conclusion to be drawn from this brief analysis is that there is no anti-savings bias in the Barbados tax-system. Although policy has been inconsistent in some cases, there are a fairly wide range of incentives and instruments available to the investing public. However, while these incentives may influence the form in which assets are held, the major underlying influence on the level of financial savings remain the rate of growth of nominal GDP and the overall balance between direct and indirect taxation through its influence on disposable incomes.

The Financial System

The financial system in Barbados comprises the consolidated banking system and the non-bank financial intermediaries. The consolidated banking system is defined to include the Central Bank and seven commercial banks (five branches of foreign-owned banks and one privately and one publicly-owned domestic bank). The non-bank financial intermediaries include the trust companies (subsidiaries of the commercial banks), two publicly-owned entities - the Barbados Development Bank and the Barbados Mortgage Finance Company - and three finance companies. Other non-bank financial institutions include a number of general purpose and life insurance companies, credit unions and consumer societies and four offshore banks. Completing the structure of the financial system is the Securities Exchange which began operations in 1987.

Commercial Banks

The commercial banks dominate the financial system capturing about 80% of private sector financial savings. The other significant recipients of financial savings are the trust companies which in the period 1984-86 controlled about 10% of the total deposits of the consolidated financial sector. The remaining 10% is shared between the finance companies, credit unions and the offshore banks. The dominance of the commercial banks, however, has been reduced as a result of the diversification of the financial system and the emergence of several new intermediaries. Thus in comparison with the current situation, in the period 1974-76 commercial banks captured some 85% of private sector financial savings.

Total deposits in commercial banks rose at roughly the same rate as nominal GDP between 1974 and 1984 and at a faster rate in the period 1985-87 more likely reflecting the increase in disposable income resulting from the

marked shift from direct to indirect taxation. The same trend is reflected in the movement of deposits held by various classes of depositors. Up to 1984, households contributed about 60% to the total, with business firms and financial institutions contributing between 15% - 17% each. Since 1985 there has been a significant increase in the share of deposits contributed by households with the figure reaching as high as 65%. Apart from the effects of the change in tax policy, there has been a slowdown in the build up of deposits by financial institutions as the government has utilized a greater part of the surplus of the National Insurance Fund to finance its burgeoning deficit and the insurance companies allocated more of their funds to satisfy the strong demand for residential and commercial mortgages. With the increase in disposable income and the narrowing of interest rate differentials an increasing proportion of deposits are being held in the form of savings as opposed to time deposits.

With the slowdown of economic growth since 1980 and rapid build up of deposits considerable excess liquidity has emerged in the banking system. This is revealed in several ways. For instance, the ratio of loans to advances which was 86% in the period 1974-76 had declined to 76% in the period 1984-86. Again, cash reserves held by commercial banks remained in the 1980's above the required level and (as noted earlier) the banks have been holding over the past four years 25%-30% more of stipulated government securities than required by the Central Bank.

During the past ten years, available evidence points to a significant shift in the distribution of loans and advances by economic sector. As discussed earlier, the critical factor in analysing the role of financial

intermediaries is the extent to which financial savings gets transformed into physical assets. Because there is no published data which would permit such a detailed analysis to be undertaken, a rough approximation of the extent of such transformation would be the proportion of credit allocated to what could be described as the productive sectors and to the sector which contributes most to private consumption. The former consist of tourism, manufacturing, agriculture, public utilities and construction and the latter the personal and distribution sectors.

Loans/Advances by Sectors

% of Total

	<u>1974/76</u>	<u>1984/86</u>
Tourism	11.6	12.4
Manufacturing	9.3	14.2
Agriculture	4.0	4.0
Public Utilities	6.0	8.2
Construction	<u>11.6</u>	<u>14.2</u>
	<u>42.8</u>	<u>53.0</u>
Personal	25.0	22.
Distribution	<u>17.5</u>	<u>14.</u>
	<u>42.5</u>	<u>36.</u>

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In the ten year period, the proportion of total loans/advances going to the productive sectors rose from 42.5% to 53%, while that going to the

personal and distribution sectors declined from 42.5% to 36%. The same trend is illustrated by the fact that consumer credit outstanding declined from 12.4% to 10% of total credit between 1974/76 and 1984/86. As the commercial banks have shifted their focus towards the productive sectors, some of the newer financial intermediaries - finance companies and credit unions - have moved to fill the gap.

As the commercial banks have expanded their lending to the productive sectors, there has been a corresponding change in the maturity structure of their loans as the following data indicates.

Maturity Structure of Commercial Bank Loans

	% of Total			
	<u>Overdrafts</u>	<u>Under 3 years</u>	<u>3-5 years</u>	<u>Over 5 years</u>
1974/76	46	27	13	14
1984/86	41	18	10	31

Maturity Structure of Credit to

Productive Sectors

% Over 5 Years

	<u>1974/76</u>	<u>1984/86</u>
Tourism	3.4	26.0
Manufacturing	32.0	49.0
Agriculture	26.0	16.0
Public Utilities	0.0	74.0
Construction	21.0	16.0

There has been a significant shift in the proportion of loans/advances to the private sector lent for periods in excess of 5 years from 14% of the total in 1974/76 to about one-third ten years later. Within the productive sector, loans to the tourism and manufacturing sectors and for the development of public utilities are increasingly longer-term. (The reduction in the term of lending to the agricultural and construction sector probably reflect the fact that other financial intermediaries - the Agricultural Division of the Barbados National Bank and the finance companies - have emerged as alternative sources of finance).

Non-bank financial intermediaries

The trust houses of the commercial banks have emerged in the past decade as important intermediaries in the financial system. Between 1980 and 1985 their deposit base increased by over 200%, from 4.3% of total deposits of the financial sector to 10% between 1974/76 and 1984/86. Trust houses engage almost exclusively in long-term lending. Accordingly they only seek longer term deposits, and to attract such deposits have to pay a higher average borrowing rate.

Trust houses specialise in mortgage lending. Indeed they were set up by the commercial banks for this specific purpose presumably to ensure a better matching of assets and liabilities. Thus currently only some 4% of commercial bank credit to the private sector is in the form of mortgages. Some two-thirds of the trust houses lending is for residential mortgages and the balance for commercial mortgages. Because the residential mortgage rate is controlled by the Central Bank (currently 9%) commercial mortgages which carry higher rates of interest are of considerable importance in determining overall profitability.

The trust houses are one of a trilogy of institutions which cater to the mortgage market, the other two being the insurance companies and the publicly-owned Barbados Mortgage Finance Company (B.M.F.C.). A quarter of the total credit to the private sector goes into mortgages. The trust houses account for 40% of the total, the insurance companies for about 30%, the B.M.F.C. 20% and the commercial banks 10%. The B.M.F.C. provides finance mostly to lower and lower middle income groups and is funded by long-term loans mainly from the National Insurance Fund.

The Insurance Companies which together provide about 10% of total credit to the private sector have become increasingly important in the process of financial intermediation. There is no up-to-date consolidated data on the insurance industry but total annual premium income generated by the life and general companies is probably in the region of \$150 million. The life companies are increasingly moving to meet the demand for investment products by marketing a variety of fixed and variable rate policies. Because of their need for a high degree of liquidity, general companies hold 70% of their assets in the form of short term deposits and government paper, while the life companies with longer-term liabilities hold about 60% of their assets in the form of mortgages and real estate. In total the insurance industry holds only 5% of their consolidated assets in shares, reflecting the shortage of marketable shares rather than any reluctance to hold equity as such.

The other non-banking financial institutions of some significance are the finance companies and the credit unions. At the end of 1986, the three finance companies then operating had combined assets of \$40 million and only 2% of the total deposits of the financial sector. These institutions lend for the lease or purchase of private motor vehicles, taxis and other commercial vehicles and construction and office equipment. About 20% of these

loans/leases could be classified as for consumption purposes, the major proportion therefore being for lease/purchase of capital equipment. These finance companies have tried to fill a role - namely the lease/purchase of vehicles and equipment - which the commercial banks for various reasons have not found attractive and which is not being adequately filled by any other institution.

The main problem with these companies has been that all are under-capitalised and some have been badly managed but have not been subject to Central Bank control and regulation as have been the commercial banks and trust houses. Because there has been no minimum capital requirements and restriction on the size of loans nor in relation to paid-up capital etc., imprudent lending policies (lack of adequate security) led in one case in 1987 to the collapse of the operation with the consequent loss of depositors money. Legislation to bring the finance companies within the ambit of the Central Bank's control is pending.

The financial institutions which have shown the most rapid growth have been the credit unions. Although they remain small in relation to the banks and insurance companies, they have increased in number from 23 in 1980 to 40 in 1986 with total membership moving from 5,500 to 20,001 and total assets from \$5.5 million to \$42.2 million in the same period. The credit unions mostly lend for home improvement, real estate and purchase of motor vehicles and other consumer goods. Indeed their rapid growth is probably not unrelated to the fact that as they are not subject to Central Bank regulations they have permitted their members to circumvent the Hire Purchase and credit restrictions formerly imposed by the Bank particularly in the purchase of major consumer durables.

The remaining non-bank financial institution of significance is the

Barbados Development Bank (B.D.B.) Although it is not a financial intermediary in the sense of raising deposits to make loans, it is important as the major conduit for channelling long-term funding from international institutions like the World Bank, the Inter-American Development Bank, the European Investment Bank and the Caribbean Development Bank to the productive sectors of the economy. As such it is a major source of foreign exchange for development purposes and of long-term finance. While it typically charges market rates of interest for most of its loans, it can offer loans with maturity up to 15 years.

Although its loans comprise less than 10% of the loans of the financial sector, the B.D.B. is a significant lender for capital projects of the tourism and manufacturing sectors. Its loans to the tourism sector are equivalent to 50% of commercial bank credit and for the manufacturing sector about 25%. It often co-finances projects with the commercial banks, providing the long-term funds with the commercial banks providing the working capital. As a development bank, the B.D.B. has been able to finance worthwhile projects which do not meet formal commercial bank criteria and has also been able to reschedule debt when its clients have faced recessionary conditions. It has also been able to be innovative and open special windows for groups - small manufacturers and operators in the service industries - who would have difficulty in accessing commercial credit.

However as a consequence of this approach and of the inevitable political pressure to accommodate special interests and not to enforce repayment conditions systematically, the Bank has built up a large non-performing portfolio. Failure to make adequate provision for bad debts in a timely fashion has forced large write-off of these debts, which has eroded the equity base of the institution. Because the Bank operates under a

government guarantee normal tests of insolvency would not apply but the fact is that as long as the Bank continues to fail to make an accepted rate of return on its investments it is using scarce resources inefficiently and imposing a cost on the rest of the economy.

Self-financing

While access to financial savings through the medium of intermediaries is vital for new and untried enterprises, well established firms with a proven track record have the alternative of financing fixed investment by internally generated cash or issuing shares. In the latter case, the decision on the method of finance will depend on a number of factors including the financial strength of the company, the relative cost of borrowing as against equity, the dividend pay out policy etc.

Although no comprehensive data are available on the sources of financing of fixed assets for the corporate sector as a whole Arthur Young International produce an annual summary of the Published Financial Statements of selected Barbadian companies. The companies are grouped into three categories - general trading, manufacturing and processing, and public utilities. The sample is not representative of a cross section of the corporate sector because it does not include firms whose principal business is tourism or agriculture, or any of the newer manufacturing operations. However, the sample includes all the companies listed on the Securities Exchange and together these firms accounted for roughly half of the corporation tax paid and a third of expenditure on fixed assets by the private sector in the period 1984-86. So while conclusions drawn from analysis of the data cannot be generalized for the corporate sector as a whole, the report is of relevance because the companies surveyed are major contributors to employment, income, investment and tax revenue in the economy.

The available data indicate that the gearing ratios of the companies in the sample remained relatively stable in the period 1984-87. As the survey notes most of the companies are low-g geared with only four of them (out of 19) having more than 50% of their total financing contributed by loan capital. In many cases, this low gearing-ratio is not the result of a policy of financing investment by issuing shares, but from the ability of many of these companies to finance their expansion internally.

Sources from which expenditure on fixed
assets and investments were financed

	<u>% of Total</u>	
<u>General Trading</u>	<u>External</u>	<u>Internal</u>
<u>Companies</u>	<u>Financing</u>	<u>Financing</u>
1984	27	73
1985	31	64
1986	15	85
1987	29	71
 <u>Manufacturing and Processing</u>		
1984	49	51
1985	18	82
1986	10	90
1987	29	71

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The pattern of financing fixed investment by the public utilities is different from the other companies in the sample because not only is their need for capital much larger but their tariffs and dividend pay out are also

controlled by the Regulatory Agency. These companies are more reliant on external borrowing and share-capital. In fact in the period under review, the only shares issued by the other companies were bonus shares to their employees. So that the overwhelming proportion of such external financing as is undertaken is in the form of borrowing rather than share issues.

The reasons for the preference for borrowing is not hard to find. Dividend yields are currently in the region of 8% to 12% making share ownership the most attractive outlet for financial savings over the past several years. As the survey observes "with the present low rates of interest prevailing in Barbados, providing a company can afford to borrow, it is true to say that debt financing is cheaper than equity financing". The differential is even more marked when account is taken of the fact that interest payments (unlike dividends) are tax deductible.

In this situation, the decision to finance investment out of retained earnings or borrowings rather than by selling new shares appears as a quite logical reaction to a given market situation. There may, however, be other factors at work. In the first place, many of the older established companies accept deposits from customers. This was a practice which developed over many years when the banking system was less competitive and the companies (particularly in the distribution sector) were able to attract deposits by offering higher interest rates. The practice has persisted, and these deposit-taking institutions remain outside the framework of regulation of the Central Bank. The deposits are of course unsecured and in fact one company which had substantial deposits went into liquidation with consequent losses to many small and large depositors. The point is, however, that the ability of some companies to attract deposits probably reduces their need to borrow long-term or issue new shares.⁶

The second factor to consider might be that to many companies their shares appear undervalued and therefore the prospect of diluting ownership by presenting a windfall to new shareholders may act as a disincentive to equity financing. The authors of the Survey note, in this regard that "Price/Earnings ratios are in most cases still very low, suggesting that there is considerable room for improvements in share prices" with 50% of the companies showing P/E ratios below 5. It is possible therefore as the market values of shares rise to more nearly reflect the earnings records and the rate of dividends paid, the attractiveness of raising capital by issuing shares may increase.

A third reason for relying on self-financing or bank-financing as opposed to equity financing is the reluctance to dilute ownership and control, especially of predominantly family-owned businesses. The importance of this factor is impossible to quantify but no doubt is significant in many cases. Although many older trading and manufacturing companies are listed on the stock exchange and so are accustomed to public disclosure and accountability, control remains vested in a minority of the shareholders who also dominate the Board of Directors and executive management. It is probable, then, that rational reaction to market forces noted above is reinforced by a continued reluctance to see control eroded by expansion of shareholding.

The Securities Exchange

Prior to the establishment of the Securities Exchange in June 1987, there was no organised or structured framework for the purchase and transfer of shares. Shares were either sold in settlement of outstanding liabilities or traded informally by trust companies or solicitors who brought together willing buyers and sellers. High transactions costs and illiquidity of share

ownership were significant deterrents to the wider acceptance of shares among the investing public.

The establishment of the exchange filled a void in the financial sector in Barbados. It created a mechanism for the orderly purchase and transfer of securities under a regime which virtually eliminated transactions costs and assured owners of such securities that their financial assets could be quickly converted to cash. In the progressive development of an effective capital market in Barbados therefore a properly functioning stock exchange which provides an outlet for the corporate and household sectors to utilise surplus funds is an important element in ensuring that financial savings can be transferred into physical assets.

A major objective of establishing the stock exchange was to facilitate equity financing of business expansion and to encourage the wider participation of the public in the ownership of private enterprise. While there has been sustained activity on the Exchange in the transfer of existing shares with share prices advancing, there has been no new issues through the exchange since the inception of trading. At the end of 1987 13 companies with 189 million shares and market capitalisation of \$243 million were listed for trading. In the six months to the end of 1987 1.5 million shares with aggregate value of \$3.6 million were traded. In the period December to June 1988 some 1.48 million shares with market value of \$4.2 million were traded.

Trading in shares as would be expected constituted only a small part of the stock of shares currently held. The factor constraining expansion of the market is the shortage of new issues. Since the Exchange began operating only one issue of 1 million shares (in a Public utility) totalling \$5 million was put on the market and oversubscribed by a factor of three but this was not issued through the Exchange.

The activities of the stock exchange constitute an essential part of the framework of a modern capital market. At present its effectiveness is constrained by the fact that equity financing is the least attractive alternative method of financing investment for established companies. However the success enjoyed to date in providing share transfers indicates that the public is willing to place their financial savings in good quality equities.

The Regulatory Framework

The regulatory framework in which the financial institutions operate is largely set by the Central Bank. While the ultimate authority for granting licenses etc. in many cases resides in the Minister of Finance the actual day to day implementation of the various enactments has been delegated to the Bank. Recognising the limits of the effectiveness of monetary policy in a small open economy like Barbados the Bank's approach has been gradualist and minimalist rather than activist and interventionist. As the Bank has increased its knowledge of the workings of the economy and its capacity to analyse trends and adjust to perceived changes in the economic environment, its policies have become more targetted and specific and less generalised in application.

The Bank has sought to articulate a mix of policies which would assist in the achievement of four broad objectives:

- (a) Protect the balance of payments
- (b) Promote sustained non-inflationary growth
- (c) Provide special incentives for priority sectors and activities
- (d) Ensure availability of adequate financing for government from domestic and/or external sources so as to avoid the need for any significant Central Bank accommodation.

It is of course not surprising that there is an element of tension or inconsistency in using the same policies to achieve differing objectives. The task of the policy-maker in these circumstances is to resolve these inconsistencies and over time it is possible to discern how policies designed to achieve one objective - protection of the balance of payments - have had to be altered to accommodate another objective - promoting economic growth.

With regard to its concern to protect the balance of payments, the Bank relied on hire purchase controls and credit controls, varying the commercial banks cash reserve and liquidity requirements and interest rate and rediscount rate policies. Thus between 1977 and 1988 the bank placed credit ceilings on the distribution and personal sectors, tightening and relaxing these in accordance with the need to maintain external equilibrium. Similarly, the cash reserve ratios of the commercial banks have been increased from 2% in 1973 to 8% currently and the holdings of stipulated securities from 3% to 22% of deposits. While recognising the critical role of public sector deficit reduction in ameliorating pressures on the international reserves, selective credit controls, varying the Central Bank discount rate and increasing the deposit requirements of commercial banks have been pursued as part of the attempt to manage the level of aggregate demand in the economy as a means of complementing fiscal policy.

Similarly interest rate policy has reflected the need to maintain a sustainable differential between domestic and foreign rates. Experience has shown that when interest rates particularly in the U.S. exceed rates in Barbados by more than about 2%, powerful incentives are created either to keep money abroad or to settle foreign debts early. Evidence suggests that these pressures lead to a loss of reserves. The Bank therefore followed a policy of maintaining a differential considered sustainable even when domestic

circumstances would indicate a lower rate structure - as for example during the recent period of low inflation and excess liquidity in the economy. Controls have been exercised through the Bank fixing minimum deposit rates, average lending and the prime rate and maximum residential and commercial mortgage rates.

Progressive relaxation of credit controls and simplification and liberalisation of the interest rate structure reflected the need to temper concern for protecting the balance of payments with the need to promote orderly economic growth through rational allocation and pricing of credit to the private sector. Beginning in 1978, a series of exemptions from the personal sector credit limits were granted till the point was reached when limits were virtually meaningless. Finally in 1987, credit controls were removed entirely. In the light of experience the Bank apparently concluded that blanket credit controls were not only unworkable but probably ineffective, and decided that macro-economic policies were more important in managing aggregate demand than credit controls, and that allocation of credit was more efficiently handled through the freer play of market force than through selective controls. Similarly, while still striving to maintain what has been referred to as sustainable differentials between interest rates in Barbados and abroad, the Bank has simplified the structure and only sets minimum deposit, average lending and residential mortgage rates.

In seeking to promote orderly growth, the Bank has developed an Export Credit Insurance and Guarantee Scheme, has provided funds for the Barbados Development Bank and provided rediscount facilities for the agricultural, tourism and manufacturing sectors. It has also, with the World Bank, set up an Industrial Credit Fund to provide medium and long-term credit to

entrepreneurs which is disbursed through the commercial banks. In targeting specific sectors, the Bank has created special facilities for small business. In its role of assisting in the development of the capital market the Bank has issued National Savings Certificates and played an active role in the establishment and operation of the Stock Exchange.

Finally, the Bank has used its power to vary deposit requirements of the commercial banks to ensure at times that funds are provided by the banking system to meet the financing needs of the public sector. In pursuing its objective of protecting the balance of payments however the Bank has been ever mindful of the need to prevent excessive reliance on the domestic banking system, including its own accommodation, and has been active in assisting in raising external loans to bolster the reserves and at the same time finance the public sector deficit.

III - Future Development of the Capital Market

Before considering what improvements or modifications may be introduced into the financial system in Barbados, it is helpful first to look at what implications the changing international environment and changing structure of the economy may have for the future level and pattern of savings and investment. The major factors likely to impact on the domestic economy appear to be;

- (1) The marked reduction in net foreign capital inflows which will result from the combination of higher debt service payments and reduced inflows of loans from multinational agencies and commercial banks.
- (2) The integration of capital markets and persistence of a regime of largely floating exchange rates.
- (3) Reduced opportunities for emigration which has in the past provided an

important outlet for surplus labour and remittances for the support of dependent relatives.

- (4) The long-term decline of the prospects for the export of primary commodities, the result of negative income elasticity of demand, development of substitutes and more efficient use of industrial inputs.
- (5) Increased protectionism in the markets of the developed countries. At the same time, the major industrial countries are forming trade groupings with each other which pose potential threats to those LDCs which have preferential agreements with one or other of these groups. Thus the Integrated European Market of 1992 and the U.S./Canada Free Trade Agreement could impact adversely on Lome, C.B.I., CARIBCAN etc.
- (6) Rapid rate of technological change in the developed countries and the need for flexible policy responses from the domestic economy. Broad and Cavanagh in an article in the Fall Edition of 'Foreign Policy' point to a series of corporate developments which have stunted demand globally, leaving increasing numbers of people at the margins of market activity; "Prominent among these are ... corporate substitution for Third World raw materials, and labour-saving technological innovations in the developed world". The bottom line, therefore is that lower labour costs is no longer likely to be a critical factor in determining locational advantage, and the quality of the human resource will hold the key to success in the twenty-first century.

For a small open economy, an external environment such as described above poses formidable challenges. What is certain is that the relatively sheltered environment of the past few decades - for example, special arrangements for sugar, access to concessional finance, outlets for nationals to emigrate to greener pastures - can no longer be counted on in the future. The major problem facing the economy will be creation of enough new jobs to reduce the

present level of almost 20% of unemployment of the labour force. However the picture is not one of unrelieved gloom, since future developments hold out opportunities as well as pose challenges - for example the expected strong growth of trade in all kind of services. What is required is far-seeing and informed national economic management which can anticipate and plan for change, and an adaptable and well-educated work force capable of coping with rapid technological development.

Against this background, the domestic economy will undergo further structural changes. The most important emerging trends appear to be:

- Increased share of the service sector in total output and employment. This will involve the continued growth of recreational and leisure activities as the tourism industry maintains its position as the leading sector, and the further development of the island as an offshore financial centre and the premier regional location for multilateral, bi-lateral and commercial organizations operating in the Eastern Caribbean. In addition, prospects are good for the promotion of the island as a venue for establishing health and educational facilities catering to residents and non-residents alike.
- Changes in the structure of the manufacturing sector from labour-intensive to knowledge-intensive activities. While this sector will continue to cater to the domestic and regional market and possesses the potential to fill particular needs in preferential markets, it cannot perform the role of leading sector. In the article referred to above ("No New NICs") Broad & Cavanagh, after surveying the growth of protectionism and the slow down in the rate of growth in world trade, conclude that it is questionable whether

export-oriented industrialisation can be the optimal route to growth in the future.

- Continued decline in the relative contribution of agriculture to G.D.P. and employment. Sugar exports, however, so long as market access is guaranteed will be a valuable source of foreign exchange and the production of non-sugar crops and exploitation of the marine resources can make a significant contribution to foreign exchange savings.

These changes which are already reshaping the Barbadian economy can confidently be expected to intensify. Change can also be expected in the size and role of government and in the composition and structure of the business sector. In order to contain the size of the public sector deficit to sustainable proportions without raising taxation to levels which will have a clearly disincentive effect on individual effort, government will be forced to address the expenditure side of the budget. This will involve both privatisation of existing public assets and services as well as requiring individuals to assume greater responsibility for providing for their health, education, pension etc. needs. Already private profit-centred hospitals offering non-critical services funded through private health insurance are being established.

Other emerging changes in the private sector have implications for the functioning of the capital market. There has been a marked increase in the number of small businesses. For example, in the retail sector, the one-stop general purpose shop has virtually disappeared as the market has become more sophisticated, and small specialist shops have taken their place. Similarly in the tourist sector many small operators provide services in water sports, catering and entertainment. Many more people are also self-employed - for

example in the professions, in repairs and maintenance, etc. These changes produce new needs which the institutions and regulators must move to meet.

Development of the Capital Market

For a country of only a quarter million people and G.D.P. of \$2.6 Billion, Barbados has a relatively well developed and diversified capital market. There are a range of functioning financial institutions catering to the diverse needs of the borrowing public. In the past decade, the needs of the productive sectors for short- and medium-term finance have been increasingly addressed and with the establishment of the Stock Exchange, the institutional structure for transferring financial savings into physical assets is now virtually complete. Where deficiencies have been identified, mechanisms to address these have been put in place. Thus, when the availability of export financing was considered a constraint to the growth of exports, the Central Bank introduced special credit and guarantee schemes. Similarly, when the needs of the tourism, manufacturing and agricultural were not being adequately met by the commercial banks, the Central Bank introduced special rediscount facilities.

Therefore, with one exception which will be discussed shortly, there are no obvious institutional gaps in the capital market in Barbados. This is not to say that there is no room for improvement in the operations of the existing institutions. Indeed, in both the privately- and publicly-owned institutions there appears to be scope for new initiatives which could impact positively on the efficiency of the transformation process. In particular, although there are six commercial banks operating in Barbados, the market is more oligopolistic than competitive in nature, as is evidenced by the uniformly high cost of services provided, which is reflected in the quite large differential between the average borrowing and lending rates. In this regard,

the publicly-owned bank has had no visible impact in stimulating competition, which was supposed to be one of its main objectives.

Despite these deficiencies, however, it is true to say that the major determinants of the extent to which domestic financial savings are transformed into long-term investment are economic rather than institutional in nature. In a small open economy like Barbados' a critical factor is the level of external demand for domestically produced goods and services. This in turn is largely dependent on the trend of economic activity in the economies of major trading partners, but is also affected by domestic factors such as the level of international competitiveness, the regulatory framework, the system of tax incentives etc. In addition, of course, the availability of viable investment opportunities is also powerfully influenced by such factors as the presence or absence of professional and other skills. The size, composition and method of financing the public-sector deficit is also of relevance since over-reliance on the banking system to finance public consumption can depress the level of private sector investment.

Nevertheless, institutional deficiencies can and do affect the efficiency with which financial savings are used - i.e. the extent to which there is a match between the effective demand for and supply of funds, leading to increase of the physical and human capital assets of the country. At present two important needs appear not to be adequately met - the need for risk capital and for more long-term financing.

While the gearing ratios of the well-established companies are low, one of the best documented and frequently discussed problems facing enterprises on start-up in the hotel, manufacturing and agro-industrial industries is the pressing lack of risk capital for equity financing. In the case of small hotels and apartments, for example, land often constitutes all of owner's

capital and virtually all the capital required for development is borrowed. In this and similar cases in the manufacturing sector debt can constitute up to 90% of total financing. As a result of this significant under-capitalisation, once financial difficulties arise, debt-service payments become unsustainable and default occurs. Because investments in these start-up enterprises are viewed as being too risky, the public is unwilling to participate directly so that entrepreneurs with good ideas but no collateral cannot get started. Concessions granted to encourage increased share-ownership such as the allowance against tax liability for purchase of new shares are of little effect in this regard since the average investor perceives the level of risk involved in investment outside the traditional companies as unacceptable.

The capital market as presently structured does not provide an adequate proportion of resources for high-risk operations. To address this problem the Central Bank has been promoting the idea of the establishment of a Venture Capital Corporation (V.C.C.). As proposed, the V.C.C. would provide equity, long-term loans and support services to small and medium sized businesses, especially in the manufacturing sector. The Corporation would then not only share the risk of investment with the shareholders of the company in which it invests but would provide advice of a technical, managerial and marketing nature as well. To have maximum impact, the V.C.C. would have to be properly staffed to spot project proposals with good chances of success. Potential for growth and expansion and modernisation would be the main criteria for selection.

To perform its function of making financial savings available for equity investment, the V.C.C. should be funded principally by the private sector financial institutions. Although initial support by way of tax concessions

and capital subscription from the government would be necessary, there is a good possibility that an efficiently run Corporation could attract external funding from institutions like the International Finance Corporation, the World Bank and the Inter-American Development Bank.

While the establishment of a Venture Capital Corporation would directly assist those enterprises which are unable to raise risk-capital directly, in the long run, the Stock Exchange, to make a major contribution to raising new capital for business expansion must expand the range of its operations or it will remain of peripheral importance in the capital market. The priority must be to get more public companies listed. Beyond this, however, the present Exchange Control rules which make it rather cumbersome for non-residents to trade needs revisiting. As one of the strongest regional economies at the present time, Barbados stands to gain from liberalisation of capital movements. Opening up the buying and selling of shares more to regional and even international investors might well provide the basis for an expansion of trading activity, an increase in share values and an increase in equity financing for business expansion. There is no doubt that the compartmentalisation of regional capital and labour markets through application of national foreign exchange and work permit regulations have made it difficult for regionally-owned businesses which operate in many territories to do so with maximum efficiency.

Although the data confirm that commercial banks over the past ten years have progressively increased both the proportion of credit allocated to the productive sectors and the proportion lent over five years, as Dr. Delisle Worrell, Director of Research at the Central Bank states "the maturity structure of finance for investment remains most unsatisfactory".⁸ The experience of the Barbados Development Bank referred to earlier indicates that indeed the commercial banks' reluctance to get involved in many of the

projects on offer is not just ultra-conservative business practice, since many have proven to be failures. However there is both the scope and the need for the banks, as the major recipients of financial savings, to become more involved in long-term lending. The conventional argument that as they borrow short they can only lend short is unconvincing, since their deposits are stable and expanding.

A suitable vehicle to encourage the banks to devote more resources to the long end of the market could be an expanded Industrial Credit Fund. This revolving fund, set up with World Bank and Central Bank money has been quite successful in involving the commercial banks in getting more familiar with and accustomed to appraising projects for long-term financing. The amounts disbursed have been modest but the learning experience for the staff must have been valuable. The original World Bank loan has been drawn down and when the Fund is replenished, the opportunity should be taken to enlarge its size by inviting the banks to commit more of their resources in joint financing arrangements. In addition to normal long-term lending, the fund should specifically target export-oriented activities. A technical assistance component should be added to enable special training to be offered to the staff to permit them more readily to evaluate projects on the basis of economic and financial criteria and not on the adequacy of security alone. In this way, the banks themselves would be better equipped to assist prospective investors in formulating project proposals that advance especially the small business sector.

Facilities for long term lending could also be improved if a market in corporate bonds could be built-up for trading on the Stock Exchange. If the Central Bank (as it should) does tighten up on the practice of deposit-taking by firms, it is likely that it will gradually be phased out. As an alternative, these firms and others could find that raising long-term capital

by the issuance of convertible stock or fixed-rate bonds a cheaper form of finance than commercial bank borrowing. It might be necessary initially to get such issues underwritten, and for an appropriate fee insurance companies or the commercial banks could be encouraged to undertake the underwriting once some degree of liquidity is assured through trading on the Exchange.

One benefit of increasing the variety of instruments tradeable on the Stock Exchange would be to improve the prospects for the operation of an institution which up to now has only had moderate success in Barbados - the Mutual Fund. These funds are supposed to offer the investor the advantages of diversification and professional management, but in Barbados because of the paucity of traded paper, the one fund operating has not been able to offer competitive yields, although it has attracted some interest as purchases of its shares qualify for tax concessions. However, the fund offers real possibilities for bringing into the market, many small savers who now are probably excluded. To the extent that corporate bonds, government bonds and equities are traded on the Exchange, the Mutual Fund should become a much more viable institution.

At the macro-level, there are many factors inhibiting the development of the export sector, which is important for stimulating future economic growth and raising levels of fixed investment. The Barbados Export Corporation, the government agency charged with promoting exports, has identified poor quality, deficient design, uncompetitive pricing, slipshod packaging, inadequate market research and lack of capacity as major inhibiting factors in constraining the growth of exports. There is therefore a pressing need for product development, market development, and research and development on the basis of which informed investment decisions can be made. In addition, in areas such as furniture-making and garment manufacture many firms need new equipment and

modernised work places. There is also a lack of resources for refinancing. Sometimes an undercapitalised business experiences temporary financial difficulties - perhaps caused by failure to up-date technology or loss of market share - and needs refinancing, while steps are taken to deal with the problems. At present, such a business would likely go under because existing financial institutions by and large are not geared to refinancing such businesses.

There is a need to allocate more resources to cater to these various needs. In some cases - e.g. product and market development - there is no reason why funds should not be forthcoming from the commercial banks once such expenditure is seen as essential components of a viable proposal. With regard to refinancing and research and development it might be necessary, through loan guarantees or establishing separate funding, for the government to take the lead in ensuring the availability of funds.

An economy which becomes progressively reliant on knowledge-intensive services and industries for employment will require a labour force with a wide array of skills - professional, technical, managerial and supervisory. Accordingly, creation of a more organised structure for channelling funds into investment in human capital will become a priority. As responsibility for financing tertiary level training of all kinds becomes increasingly the responsibility of the individual, facilities for medium- to long-term lending will have to be put in place. At present funds are either made available through the Student Revolving Loan Fund which has a maximum income criteria, or through commercial bank borrowing usually for very short periods (but sometimes through mortgages for longer periods). While problems of repayment are common to most educational loan schemes, a properly structured system of loans through the commercial banks (with appropriate guarantees) with the

main security being mandatory deductions from future income (as is the case in some Nordic countries) should be feasible.

Finally, attention should be paid to reversing the quite dramatic decline in private foreign investment which has occurred since the early 1980's. While this is partly reflective of a global trend, as well as the relative loss of competitiveness of the economy, the role of private foreign investment in the past in bringing new technology and markets and raising the level of skills calls for a special effort to identify and encourage the formation of joint ventures to exploit in particular the opportunities opened by access to markets of the E.E.C., the U.S.A. and Canada under preferential arrangements. This would require more intensive promotion, improved training facilities, and a serious attempt to improve the efficiency with which the bureaucracy processes the grant of various permissions and licenses. In addition, it could require a more liberal approach to the access of foreign investors to short- and medium-term loans for working capital purposes.

S.E. Entage

February 1989

NOTES

Currency: Barbados \$. BDS\$1.00 = U.S. \$0.50

1. When this survey was being compiled, firm data was only available for 1987 and in some instances, 1986. Preliminary data for 1988 suggest that real GDP increased by between 2.5% - 3.0%, based mainly on a strong performance in tourism. There was consequently some modest improvement in the level of foreign reserves. However, visible exports remained weak and unemployment high.
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