Finance and Investment in Barbados by Delisle Worrell

Paper presented at
The Conference on Financing Development in the Caribbean
Sam Lord's Castle, Barbados.
December 4 to December 8, 1989

CONFERENCE ON
FINANCING
DEVELOPMENT
IN THE CARIBBEAN

The Conference on Financing Development in the Caribbean is sponsored by Commonwealth Secretariat, Regional Programme of Monetary Studies and The Central Bank of Barbados.

Cooperating and supporting institutions: CARICOM, Caribbean Development Bank, Economic Commission for Latin America and the Caribbean, Commonwealth Fund for Technical Cooperation, Canadian International Development Agency and The World Bank.

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Central Bank of Barbados

May 1989

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Barbados has attracted substantial amounts of commercial foreign financing in the 1970s and 1980s, both for government and the private sector. In the seventies and the early eighties there was a fairly even mix of funds for the public and private sectors, in some years in quite considerable amounts, but at other times very little. More recently, the finance has been mostly for government, and borrowings have been sustained, year after year.

There are fears that the extent of foreign financing may have inhibited the activity of domestic financial institutions, and that commercial financing may have accelerated an outflow of foreign exchange for debt servicing. Alternatively, it has been suggested that the available foreign financing may have been insufficient, and that access to foreign finance was limited. In these circumstances investment may have fallen short of the economy's potential, or investment may have been too costly in foreign exchange.

In an effort to illuminate these issues this paper examines investment trends and considers the factors which have influenced them. We look at financing from all sources, considering the relative importance of foreign commercial financing and the factors that might have accounted for it. The paper goes on to domestic financing and the institutions which support it, with some comments on their adequacy.

Capital Formation and its Financing

Investment trends appear to have been driven by the prospects for the Barbados economy. In the second half of the 1970s there was a recovery from the effects of the 'first oil shock' (1973/74); it was based mainly on growth in tourism and in manufacturing, much of the latter destined for nearby Trinidad and Tobago, which benefitted from the oil boom. Investment opportunities in tourism and manufacturing were exploited in these years. Their growth stimulated domestic demand, including the demand for housing and public utilities, which also became areas of investment activity.

Barbados' economic prospects were clouded in 1981 by the recession in industrial countries - the major sources of tourists - and by the economic misfortunes of its neighbours, whose ability to purchase Barbadian exports contracted as their real incomes declined. Declining living standards in competing Caribbean countries meant that real wages fell relative to those in Barbados, diverting investment to these less expensive destinations. Barbados failed to adjust with sufficient alacrity, to adopt more advanced technology, to instal flexible organisational arrangements and to develop managers who combined highly developed skills with a demonstrated capacity to produce results. As a result investment declined in the leading traded sectors, and investment in public utilities and housing soon followed suit.

The export situation was not rectified, but from 1985 government boosted economic output on the basis of domestic demand, originating with fiscal expansion. There was renewed investment growth, based mainly on government foreign borrowing. Government foreign financing reached an unprecedented 30% of gross capital formation in 1987. The expansion created additional demand, including demand for mortgages. Private investment, both domestic and foreign, was on a downtrend in the mid-1980s, with increasingly large net foreign outflows. Government substituted for private sector overseas borrowing, but its investment failed to create capacity to earn additional foreign exchange for future debt service, so this policy could not be long sustained.

Gross capital formation rose quickly from 1976 to 1981, mainly on the basis of private sector financing and mortgages. The private financing was contributed about equally by domestic and foreign sources. Government savings on current account and the issue of public domestic debt were also important, along with a lesser amount of government foreign borrowing. Most government borrowing was for projects, with only occasional market borrowings.

Capital formation slumped badly in 1982-85, with private foreign financing showing the largest decline: there were net outflows from 1983 onwards. Debt repayment kept government's domestic financing low, and government may have been afraid of crowding out the private sector on credit markets. Private domestic financing was on the increase, but not in amounts sufficient to maintain overall investment levels, and mortgages and investment by public utilities were down.

The years 1986 and 1987 saw a resurgence of investment, in response to fiscal expansion. Government foreign borrowing was the largest element of financing, with mortgages also contributing to the increase.

Private foreign investment was a very substantial factor behind the trends in overall investment. It was an important source of finance for the 1976-81 upswing, though by the late 1970s investment had already begun to slacken. Increasing repayments by joint venture companies, public utilities which had undertaken expansion programmes in the 1970s, and private sector companies led to net private capital outflows. For the most part private investment was in the form of loans; direct investment was of significance only in 1975 ($45 million) and in 1978 ($18 million).

Private domestic financing made a considerable contribution to investment throughout the period. Our data do not fully reflect this, because of the paucity of information on the retained earnings which firms ploughed back into business. We suspect they were the largest single source of financing for most years, though we have only partial information for a sub-set of publicly quoted companies. Long term loans by commercial banks (loans with maturities of five years or more) are the largest identified source of finance. These loans declined in 1978, rose through the lean investment years of the early eighties, and expanded again in 1986.

Mortgages played an important role in the rise in investment in the late 1970s. The market was badly affected by the 1980s recession, and a decline set in which was arrested only in 1986 and 1987. Mortgages tend to exaggerate the swings in the overall economy, in a way that has been observed in many countries.

Government domestic financing made only a small contribution to the trends in capital formation. During the 1970s expansion government repaid domestic debt. Government current account surpluses made a useful contribution to financing between 1974 and 1977, when the investment boom was just getting underway. In the recent fiscal expansion government domestic borrowing was quite high, but the current account surplus was completely eroded.

Government borrowed little from abroad up to 1977. Thereafter foreign borrowings were at modest levels, mainly increasing amounts of project funding. Around the time of the 1980s recession government project financing eased, and there were no market borrowings. An IMF standby agreement was the other source of foreign funding in the early 1980s. There was a sharp turnaround in policy from 1985 onward. Previously government had shadowed private investment, but government now took the lead, with very large foreign loans in 1985, 1986 and 1987 which filled the gap left by net outflows of private foreign capital.

<u>Foreign Financing</u>

During the period of strong investment growth from 1976 to 1981, private foreign inflows were consistently high. They provided 10-40% of total capital formation, except for 1979 and 1980. Private inflows were reversed from 1983 onwards, with net repayments equivalent to over 10% of investment in some years. Government foreign borrowing played an important part from 1976 onward, but until 1984 it was very much subsidiary to private foreign inflow, amounting to 5-18% of the total. After 1984 government foreign borrowing became the foremost item of finance, between 21% and 30% of the total.

Private foreign investment in the late 1970s concentrated in the manufacturing sector and public utilities, for the most part. The public utility borrowings were sometimes supported by government guarantee. The borrowings were not flotations on the open market, although funds were provided by international banks in many cases. Usually arrangements were made by foreign partners in the enterprise or by branches of international banks operating in Barbados, through their overseas correspondents.

Government's market borrowings, significant but infrequent up to 1984, intensified from 1985 onward. In each of the last three years of our investigation market borrowings by government were in excess of 20% of investment of all kinds and 68-81% of investment in finished goods. Government project funding from abroad varied from year to year, but within limits that maintained a reasonably constant contribution to total investment.

Private foreign borrowings were in the form of intra-company loans, borrowings from foreign commercial banks and a little direct investment. The main recipients were the public utilities - to expand electricity generating plant and to upgrade telephone services - manufacturers - for garments, electronics assembly and sugar processing - and insurance companies.

Government project financing was mostly for infrastructure, but there were several large borrowings from international banks for state corporations engaged in producing marketable commodities. Major loans were contracted with foreign governments and with multinational financial institutions such as the World Bank, the Interamerican Development Bank and the Caribbean Development Bank for the construction of a new airport terminal, extensions to the seaport, construction of new highways, fish marketing facilities, health centres and schools, among others. Major borrowings from overseas commercial banks went for the establishment of a cement plant and the purchase of oil drilling facilities, both by state owned companies. The loans were arranged, as in the case of the private sector companies, by foreign institutions with an interest in the projects.[1]

Before 1984 government borrowings from international banks were all on eurodollar markets, with the single exception of a bond floated in Trinidad and Tobago. There were sizeable drawings in 1973, 1978, 1980 and 1981. The euromarket continued to be a major source of funding after 1984, with the largest dollar loan on record signed in 1986 for US$60 million. In 1985 the Barbados government made its first large flotation in yen (5 billion) and followed with 4.3 billion yen in 1986. In 1987 a UK consortium arranged a loan of 27 million sterling, the first sterling market borrowing for Barbados since the late 1950s.

The promising outlook for electronics assembly in the 1970s was the main motivation for much of the foreign private investment in that period. Over $5 million per year came in for investment in electronics between 1979 and 1982. The firms based in Barbados - an Intel subsidiary was the largest of them - concentrated heavily on the assembly of parts for microcomputers. Barbados lost that market when the demand for microcomputers hiccupped in 1983, and it never regained a foothold when the demand for PCs rebounded even more strongly. There was some investment in hotels, ironically towards the end of the period of fastest expansion in tourism. There was a little investment in clothing almost every year, though the prospects in this area always seemed uncertain. There was modest investment in chemicals, aimed at production for the Caricom market. There was a surprisingly large investment in insurance.

Government does not seem to have followed a single line of reasoning in its decisions on project financing. There were some projects which were designed to earn or save foreign exchange towards the costs of servicing the foreign debt - for example, the cement plant. In other instances the terms of the loan seem to have been the deciding factor. When external earnings were weak, as they were for most of the 1980s, any funding with sufficiently long maturity seems to have been sought after, even where the project involved did not have high priority or where more economical solutions (which might not have attracted foreign funding in similar amounts) were readily available. Many project loans were for essential infrastructure, as were loans for private utility companies which government undertook to guarantee. Foreign commitments were also motivated by the proportion of foreign expenditure in the cost of investment.

Market borrowings increased in importance as Barbados maintained its international credit rating more successfully than did most third world countries, and as government officials improved on their knowledge of and skills in approaching the international capital markets. The country's credit rating reflected an unblemished record of foreign debt service, and favourable international assessment of its economic policy. The government was able to tap foreign markets whenever it judged that projected foreign exchange levels failed to provide a sufficiently comfortable margin of security.

Domestic Financing

In the immediate aftermath of the 1973/74 recession government made the largest domestic contribution to investment. There were sizeable current account surpluses and substantial government borrowings from local sources. As the economic expansion got underway government seems to have made way for the private sector: debentures which matured were not rolled over and there was little new borrowing. Government's domestic contribution went up temporarily because of a large current account surplus in 1983; thereafter the surplus contracted rapidly and a deficit emerged in 1987, a pattern which reflects government's priming of the economy by fiscal stimulus in the mid 1980s.

Identified private domestic financing played an important role in funding investment throughout the period.[2] Right after the 1973/74 recession mortgages grew rather slowly, and private finance for investment was considerably below government's contribution. However, the expanding economy brought a steady increase in private financing, which continued to 1984. Mortgages increased rapidly to 1979, but fell off sharply during the second recession. Active government support for mortgage lending, together with fiscal provisions which led to increases in disposable incomes, produced renewed growth in mortgages from 1985 onwards. The recent fiscal stimulus failed to bring forward any domestic financing, apart from mortgages.

Mortgages are provided by commercial banks - to a limited extent, in comparison with their total loans - finance corporations (some anachronistically referring to themselves as 'trust companies'), insurance companies and the state-owned Barbados Mortgage Finance Company. The 1970s saw finance corporations come to the fore in the supply of mortgage funds. The largest banks usually provide their mortgage finance through subsidiary finance corporations. The finance corporations offer depositors longer maturities and higher rates than the parent banks will carry, and they try to fund mortgages out of the funds they can attract. The parent bank will sometimes 'lend' surplus funds to cover excess demand for mortgages, or accept a deposit from the finance corporation if the latter is in surplus. The rationale for these relatively small specialised institutions has always escaped this writer. The somewhat longer maturities on their deposits do not significantly improve the match between loans - with typical maturities of 20 years - and deposits, of which there are hardly any in excess of three years. In any case it is the size of the deposit base and the spread of maturities which insures any financial institution against illiquidity, not the matching of maturities on both sides of the balance sheet. A bank with $100 million in deposits may safely lend $10 million for 20 years, even if all its deposits are at call; a bank with only $10 million in deposits may not, even if all its deposits have three year maturities. If it is argued that finance corporations have specialised training in the processing of mortgages, it is hard to see why these skills might not be imported to the parent bank, with cost savings from the elimination of separate overhead. So long as the finance corporations are fully incorporated in the operations of their parent organisations not much is lost, but these small mortgage offshoots would be at risk if they are set on their own.[3]

The introduction, in the early 1970s, of legislation requiring insurance companies operating in Barbados to invest a proportion of annual premium income in local assets was a considerable boon to the mortgage market. Mortgages have the long maturities which suit the insurance companies' liability structure, and real estate is the only other local asset which is readily available in amounts which the insurance companies require. Insurance companies have become the second largest source of mortgage finance in Barbados. (Their holdings also include real estate and small amounts of government and private - but mostly government guaranteed - securities.) Exchange rate fluctuations, a highly unpredictable feature of the 1970s and 1980s, may have persuaded some insurance companies to hold local assets above stipulations, to ensure against exchange losses on local claims.

The demand for mortgages depends on the distribution of income. Barbados' pattern of income distribution is relatively egalitarian, but the heaviest demand for housing is inevitably in the lower income brackets where profit margins for house builders are small. The Barbados Mortgage Finance Corporation focusses mainly on loans for the lower middle class, a grouping that has been rather loosely defined at some times. It is the third largest source of mortgage finance in Barbados.

Retained earnings are the most significant source of finance for the purchase and installation of finished capital goods, though most of this finance remains undocumented. The amounts set aside for reinvestment will largely reflect firms' judgement about future profitability in the area chosen for investment. Commercial banks contributed substantial amounts of long term funds for most of the period, though there were two years (1978 and 1986) when firms made net repayments to banks. Funding for long term projects was available from banks for established firms who had a strong track record. The limit on financing available to such firms depended on their capitalisation and on the expected returns from the project to be financed, not on any ration imposed by the banks. Bank funds were rationed only for new firms with no connections to established companies. New share issues were quite infrequent, and they made a minimal contribution to overall financing of investment, even though all issues during the period were fully subscribed, almost immediately on issue. The investment bottleneck appears not to be finance, but the reluctance of established concerns to undertake new capital ventures. None of the large companies which might have afforded to do so have set up an active venture capital fund to search out activities which might offer scope for future investment. The prospects for expansion in the existing lines of business were not very promising in the 1980s, and this shows up in the decline in long term bank finance from 1985 onwards.

Bottlenecks and Initiatives for Domestic Finance

The slowdown in private investment in Barbados in the late 1980s is a measure of the uncertain prospects for known activities and the need to forge new export strategies. It is a problem less of finance than of entrepreneurship. Institutional arrangements must be encouraged that will foster a spirit of enterprise. The range of relevant issues is very wide, from educational policy through the structure of taxation to the extent of pay differentials for skills. The record on the promotion of new ventures - and in particular those that will earn foreign exchange - is not yet respectable. The most recent suggestions have been for a private venture company for tourism promotion, for which $3 million was subscribed in 1987 (but which is still to begin work at the time of writing) and a proposal for a venture capital company which would be jointly owned by banks, insurance companies and other private sector institutions (It is still in the discussion stage).

A second bottleneck is the prevalence of high debt-equity ratios, and the need for more equity finance. New companies will not attract equity from the public; they must depend on the subscriptions of interested parties. Often their principals are jealous of their product, process or service, and are reluctant to dilute ownership in order to secure adequate capital.

These factors have inhibited the expansion of securities trading and limited the issue of new stock to an average of less than $5 million per year in the last decade. The eagerness with which all recent issues have been subscribed indicates the potential for much larger sums. Major initiatives have been taken to encourage the growth of the securities market. They include significant tax concessions on the purchase of new shares in registered public companies, introduced in 1978; the tax relief on such purchases was very substantially increased in 1984. The income tax regulations make provision for individuals to receive credit for taxes paid by the firm on earnings from which they receive dividends.

Informal securities trading began prior to 1970 in Barbados. Arrangements were made among commercial banks through their trust departments to share information on stocks available for sale or purchase, and one institution acted as clearing house, issuing public notices of offers to buy and sell. It proved not to be a particularly vigorous arrangement, and there were long periods when no activity took place. A formal securities exchange was inaugurated in 1987 with an attractive package of shares on offer, generating a considerable upsurge in share trading. After the opening offers expired business settled down to a not unexpectedly slow pace. The Central Bank of Barbados set up a small subsidiary to help make a market in securities by buying and selling for its own portfolio as well as acting as broker for official institutions. It has yet to begin active business.

A scarcity of relevant skills at major financial institutions may be a factor inhibiting the supply of finance for certain kinds of desirable investment, particularly in exports and new products. Financial institutions seem to have little incentive to provide themselves with the expertise to evaluate projects in manufacturing, tourism and agriculture on their merits. Credit still tends to depend most heavily on the provision of physical security in the form of buildings and other durables. If financial markets were truly competitive, and if banks were staffed by entrepreneurial spirits, one would surely have seen the emergence of credit departments with particular expertise in selected areas of activity, with a view to cornering profitable niches which less knowledgeable competitors would shy away from. But the same lack of inventiveness which retards the search for avenues of profit inhibits the financial institutions. The often repeated criticism of commercial banks for relative neglect of capital formation is somewhat misguided. Commercial banks dare not enter into commitments for investment in production with their current structure and expertise. It is no coincidence that the isolated forays by individual institutions into the financing of tourism and manufacturing have resulted in such disproportionate losses that they were invariably discontinued. To manage a more investment-oriented portfolio banks would need expertise which they do not possess, and which they have so far not been willing to acquire.

For many years it has been accepted that investment might involve gestation periods which were so long that borrowers could not service commercial loans for a lengthy initial period. The Barbados Development Bank, a government institution, was set up in 1969 to provide long term finance for such cases, with long maturities and interest rates below those determined by the commercial banking oligopoly. The Bank made a minor contribution to the financing of investment - no more than 4.5% of the total in its best year, 1985, and usually more in the region of 1%. Like many other institutions of its kind in the Caribbean the Bank had an unacceptably high proportion of non-performing accounts. A lack of clear operational guidelines and insufficient administrative independence were among the reasons for the Bank's ineffectiveness. It may also be that there are relatively few activities where the gestation period is a major problem.

The Central Bank of Barbados introduced rediscount schemes to allow commercial banks to supplement their own funds as needed to accommodate producers and exporters. They first became available for lending to agriculture in 1974,and were subsequently extended for other producers. In all cases the funds were made available at special concessionary rates. The fact that trivial use was made of the schemes suggests there was no great shortage of finance. In 1983 the Bank introduced a new facility, geared towards the medium term, and partly financed by a loan from the World Bank. The initial provision of $10 million was taken up over a period of five years.

A state owned bank was inaugurated in 1978.[4] Part of the motivation for its establishment was the intention to devote a larger share of its portfolio to the financing of investment than was typical for private banks. This intention was frustrated by the failure to provide the bank with expertise of a kind that would enable it to identify feasible investment projects more readily than its rivals.

Policy Affecting Finance for Investment

There has been little change in official policies that might affect the financing of investment, in the past fifteen years. Investment and financing may have been influenced by exchange control regulations, the degree of effective protection offered via tariffs, import rebates, quantitative restrictions and tax relief, the extent of subsidies offered, interest rate policies, and the support services provided by government for investors. There have been relatively small changes in these policies from time to time; two new institutions were set up, but there has been no really major shift in the resources devoted to the support of investment.

Exchange Control guidelines affecting investment have been unchanged since 1974. Prior to 1974, Barbados was a member of the sterling area - which included members of the Commonwealth - and capital was allowed to migrate freely within that area. Since 1974 investment guidelines have allowed foreigners to repatriate capital at any time, along with a reasonable appreciation of its value. There is no restriction on the remittance of profits and management fees, royalties or other payments for investments which have been registered with the exchange control authority.

Two measures introduced since 1970 have served to increase the effective protection to firms investing in the production of import substitutes. Barbados' tarrif rates were raised in 1973 to conform with the common external tarrif embodied in the Caribbean Community Agreement. Import substitution industries gained a further advantage with the imposition of stamp duties on imports in 1982 and increases in the rates of stamp duty in 1984 and 1985. On the other hand, there was a significant reduction in the value of items subject to quantitative restrictions in the mid-1970s. The remaining quantitative restrictions, mainly applied to agricultural produce, have failed to avert the stagnation of agriculture. In an earlier study surveying available evidence of the impact of protection on the manufacturing sector, there was little evidence that the protective measures had much impact on the growth of the sector (Worrell, 1987).

Subsidies and duty rebates for investment have remained unchanged since the early 1970s. They include the provision of factory space for industrialists and duty concessions on raw materials and capital goods. A list of the provisions is to be found in Table 1 of Cox (1982). There have been one or two minor provisions enacted since that time, the most significant being the provision of training grants to industry in the 1980s.

Income tax relief has been available to foreign investors since the 1950s. The provisions were extended subsequently to domestic investment and to investment in the export sector. The provisions include tax holidays, accelerated depreciation allowances and provisions to carry over losses to subsequent profitable years. In the late 1970s a considerable rebate on export profits was introduced. Double taxation treaties with the United States, the United Kingdom and a number of Scandanavian countries permit low levels of taxation on royalties, dividends and other specified items, and provide for tax liability to arise in only one or other of the contracting countries. Legislation was enacted in the late 1960s to allow for the operation of international business companies. These companies do business entirely outside of Barbados through their offices located on the island. They enjoy a special low tax rate of 2 1/2% on profits. In the late 1970s legislation was introduced to provide for the registration of banks, insurance companies, and shipping companies to operate in a similar fashion.

Two institutions, an export promotion company and a scheme for insuring credit to exporters, were set up in the 1970s; but their operations remained quite small relative to the overall level of business generated by investing firms, so it is improbable that they made any impact on the incentive to invest or the supply of finance. Government institutions for agricultural marketing, research and finance, and for investment promotion and long term finance, date from the 1960s or earlier. The quality of service provided by official institutions has been highly variable, among institutions and over time.

Provisions affecting the tax treatment of dividends and tax credits for the purchase of shares in publicly quoted companies were the only changes that might have affected domestic financing for investment. There were minor adjustments in the allowable dividend credit. Tax credits for share purchase, initially at $2,000 and subsequently raised to $10,000, were potentially quite a strong incentive to divert funds in this direction, but there were very sparse offerings for would-be investors to take advantage of.

Prior to 1973, when the Central Bank of Barbados began operations, interest rates in Barbados followed the trends of the London financial market. Since 1973 domestic interest rates have been influenced by local policies and circumstances to some degree, but ultimately the rates are still affected by London and New York. A number of studies including Howard (1981) and Worrell and Prescod (1983) have measured the effects of interest rates on financial accumulation. No definitive answers have emerged but it seems that interest rate changes affect the choice of financial instrument, if anything, rather than the rate of financial accumulation.

Alternatives to Foreign Direct Investment

Foreign firms which discern profitable opportunities in domestic production may choose to enter arrangements with local firms instead of making direct investments. The alternatives include leasing, subcontracting and the licensing of brands. Domestic firms also may seek partnership with foreigners to gain access to expertise in marketing, production, processing or management technique. Only occasionally is additional equity an important consideration. The government of Barbados has made no effort to discourage direct foreign investment and 100% foreign ownership. Firms which have chosen avenues other than direct investment have done so for market related reasons. In the 1980s, government actively supported the idea of joint ventures, for example, in the 1983-87 plan of the Barbados Industrial Development Corporation. However, government agencies were not able to put this intention into practical effect.

Table 2, which records remittances for various kinds of foreign participation in the local economy suggests something of a trend towards licencing since 1983. Payments for royalties in the last five years were much larger, in relation to direct investment income and to interest payments, than they were in the late 1970s. The table also illustrates the relative emphasis on lending as compared to direct investment as the preferred form of foreign capital contribution.

The nature of foreign involvement in local production tends to vary with the economic activity. In tourism there has been a worldwide shift from equity investment to management contracts and leases by major hotel chains. In the 1980s one sizeable new hotel opened in Barbados, owned by government and leased to an international chain. A second international firm sold its Barbados property. A third major hotel leases its property from the government of Barbados; this arrangement dates back to the 1960s. Other large hotels are wholly or partly foreign-owned. There has been some foreign investment in medium-sized hotels but the small and medium sized properties are owned by locals.

Licencing arrangements are popular in the area of food processing and many familiar US brand names have been produced under licence in Barbados for many years. Initiatives in this area have come largely from local producers seeking to deepen their penetration of domestic and regional markets. Most often the producer makes a product under licence alongside similar items with local brand names. Comparable arrangements can occasionally be found in clothing manufacture.

There has been relatively little subcontracting of manufacturing and services, though this is a system which government has tried to promote. Some clothing manufacturers have obtained subcontracts on an ad hoc basis but few are engaged mainly in this business. One or two relatively young firms provide subcontracting of data entry services, but to date most data entry operations are tied into their parent company's metropolitan operations.

Direct investment and lending are the major sources of foreign finance for public utilities, but these are supplemented by management contracts on a fairly regular basis. In one case an association between a domestic and a foreign public utility which led to foreign investment many years ago has proved to be a continuing source of profit to the foreign partner. In another case, an international firm invested in Barbados so as to consolidate its position in the Caribbean region where it has other major investments.

Foreign investment in financial services is principally by way of wholly owned subsidiaries. They are of long standing and their establishment is linked to trading patterns. They have proved durable sources of profit to their foreign owners. In business services partnerships between locals and foreigners have gained increasing popularity. Local firms seek foreign partners to gain access to international marketing contacts and the latest in technology, while foreign firms secure a base for intelligence on the local market.

Observations on the Financing of Investment

Although it cannot be conclusively demonstrated, indicators are that a shortage of finance did not inhibit investment in Barbados. The enthusiastic reception of all new share issues in the 1970s and 1980s indicates an unsatisfied demand for such investment opportunities, and the relatively slow disbursement of funds from the central bank's medium term discount facility reflects the abundant liquidity out of which financial institutions could make advances if attractive proposals came their way. There is anecdotal evidence from individual companies that had difficulty in obtaining adequate finance and on terms that offered sensible margins for contingencies, but it would be wrong to infer that credit was being rationed globally.

The driving force behind investment was the economy's prospects and performance. Good prospects encouraged investment in the tradable sectors, and the ensuing growth stimulated mortgage lending and investment by public utilities. This seems to explain the contrast between vibrant investment in the 1970s and sluggish investment in the 1980s. In years of peak activity it is possible that specific activities such as house construction might encounter a temporary shortage of funds, but this may be readily alleviated so long as the tradable sector is expanding. If the available returns fail to bring forward additional domestic finance the growth of tradables provides the foreign earnings to support foreign borrowing.

Barbados' experience suggests that it is not difficult to access finance from international banks if a country has a good payments record and if there are strong links between local financial institutions and their parents, branches or correspondents in major financial centres. The country must also develop good information systems to obtain favourable conditions in negotiation and to supply data and analysis that convinces the market of the capacity for sound economic management.

Finance from international banks ought to have supplemented equity funding, but in fact has largely replaced it. Foreign borrowing from banks has proved more expensive, and repayments are not linked to economic cycles, so the country may find its service obligations burdensome in times of export decline. On the other hand, bank finance is without strings. The burden of judicious use of these funds rests squarely on the shoulders of the resident authorities and they must decide on the limit of prudent borrowing.
There are no links between financing from abroad and financing from

domestic sources. The two types of borrowing are for different purposes, with little substitutability between them. Government borrows abroad with an eye to the balance of payments - to add to foreign exchange reserves, to provide the capacity for future foreign exchange earnings or to cover the foreign content of investment. Government's domestic borrowing covers whatever is left of the deficit. Private foreign investment is determined by the ownership and the import content of investment. Locally owned firms almost never borrow abroad unless they need to finance heavy capital inflows.

There is an insufficient proportion of equity in domestic investment. This is largely a reflection of the size and length of establishment of the firms doing the investment. Large, well established firms have access to retained earnings and their public share issues attract enthusiastic support. Small firms will not find similar interest, and they are often reluctant to dilute ownership. The solution may lie in the setting up of venture capital companies, supported by established concerns.

Banks and other financial institutions have made a respectable contribution to the finance of investment, through long term loans and mortgages. Their major area of weakness has been a reluctance to transform their short term liabilities into assets with much longer maturities. We trace this weakness to their narrow base of expertise.

State owned institutions have a good record with respect to mortgage lending, but their financing for production has been a disappointment. They have all suffered from lack of clear policy guidelines, disorienting shifts in policy and interference in their operations and administration. As a result they failed to grow to a really influential size, and their portfolios were clogged with nonperforming loans.

The recent establishment of a securities exchange is a helpful development, enhancing the liquidity of publicly held shares. However, it is unlikely to increase the supply of equity financing. The market is short of new share issues, not of buyers.

Policy Implications

Our reading of the Barbadian experience suggests that the limit to investment has been the perception of attractive projects, rather than any scarcity of finance. Thee has, if anything, been an overabundance of finance, and a scarcity of attractive investment opportunity. Policy makers' foremost concern must be to improve the investment incentive.

The evidence indicates that fiscal incentives have only a minor effect on the propensity to invest. Direct investment by government may be used to good effect for short periods when private investment flags, but there is a great danger of excessive borrowing if this policy is sustained over many years. Our study offers no direct evidence on the possible effect of macroeconomic policies such as currency devaluation and high interest rates on the incentives to invest. There were no currency changes of any magnitude, and only brief episodes of high interest rates. On the financial side the major weaknesses seem to be insufficient innovation among banks and other financial institutions. The quality of financial services might be improved, with greater variety and more apposite financial instruments for projects of different kinds.

Policy changes might focus on the overhaul of official financial institutions where necessary to provide stronger orientation towards performance. This might involve clearer definitions of role and function, and better monitors of performance. Some fiscal incentives should be retained; we cannot say confidently that their effects are negligible in all cases, and they may serve to bolster the confidence of investors in activities which the authorities have identified as those with greatest potential. Government incentives to support the provision of venture capital and long term finance would seem to be in the right direction. Conservative fiscal policies, which keep the deficit quite low in normal times, would seem to be best, because they allow leeway for additional government investment in times of slack.

This may seem a disappointingly narrow scope for official policy to stimulate investment. Governments - and economists - like to think they are more influential. However, Barbados' relatively satisfactory investment performance may reflect sensible modesty about the effects of policy on investment. Small countries are probably well advised to avoid active exchange rate manipulation in search of comparative advantage. Exchange rate uncertainty, and the inflation that always accompanies devaluation in a small economy, both inhibit the desire to invest. And it may well be sensible to keep interest rates in line with the international financial market; speculative capital flows divert funds from investment to short term financial assets.

The provision of a sound social and economic infrastructure, a feature of the Barbadian economy throughout this period, laid the essential basis for private investment. Large numbers of citizens must participate in the decisions which result in capital formation. Government does well not to stretch national aspirations beyond the resources which these private decision makers can muster. Government should provide encouragement and a fertile environment for enterprise to flourish, but the pace of private investment may not be forced by official measures. In the final analysis, government should ensure that national spending, whether on consumption or investment, does not exceed national output and a level of prudent borrowing.

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Notes

1. The loan for the Arawak Cement Company was instigated by the Austrian firm responsible for the construction of the plant. The local bankers of the Mobil Oil Company's Barbados exploration subsidiary arranged the loan for the government's purchase of that company.

2. Recall that we have reason to believe that a large proportion of reinvested earnings goes unrecorded.

3. In fact, one finance company whose Trinidad parent collapsed in 1984 went into receivership in 1987, prompting the establishment of a commission of enquiry. This company was engaged in short term financing of consumption and goods in process. It does not feature in our analysis, which focusses on finance for investment.

4. The new bank took over the deposits and assets (mainly government securities) of an existing government savings bank, which then ceased to exist. Existing specialist banks for agriculture and for mortgage finance were attached as subsidiaries of the Barbados National Bank.

Table 1

FINANCING FOR CAPITAL FORMATION
(BDS$ Million)

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988(P)
Gross Capital Formation	167.2	156.2	235.9	238.6	254.5	317.2	424.3	525.0	450.5	421.2	373.9	371.8	423.8	466.7	
Building	100.3	76.6	148.6	152.4	155.5	184.4	229.3	326.9	288.3	313.1	275.5	273.5	304.8	334.8	
Finished Capital	54.4	74.9	82.7	83.0	92.3	114.5	116.0	191.0	166.1	101.9	104.1	90.8	122.5	125.1	
Stocks	12.5	4.7	4.6	3.2	2.2	18.3	29.0	7.1	-3.9	6.2	-5.7	7.5	-3.5	6.8	
Government Financing Domestic	42.1	40.7	32.1	53.8	20.9	25.2	52.4	45.6	62.4	104.8	64.6	65.5	66.9	59.0	
Current Account Surplus	17.9	23.4	13.1	-2.1	30.6	37.6	49.3	4.6	24.6	59.8	27.9	12.6	16.5	-1.2	61.9
Long Term Debt	19.3	16.8	11.4	40.5	-12.9	-13.4	4.0	13.7	18.4	2.2	5.7	24.6	35.0	52.7	
HIS	4.9	0.5	7.6	15.4	3.2	1.0	-0.9	37.3	19.4	42.8	31.0	28.3	15.4	7.5	14.2
Government Finance Foreign	-12.6	1.3	6.1	5.0	34.0	22.9	51.8	95.6	27.6	60.4	17.9	78.8	109.5	139.5	79.5
Debentures	16.1	0.0	0.0	-7.2	0.0	0.0	40.0	0.0	0.0	0.0	0.0	38.6	55.8	0.0	80.4
Market Borrowing	-10.9	-1.7	-1.7	-4.8	20.5	4.0	-10.9	50.0	-6.7	19.6	-11.1	36.1	28.4	96.2	0.0
Project Loans	4.4	3.0	7.8	17.0	13.5	18.9	22.7	45.6	34.3	40.8	29.0	4.1	25.3	43.3	-0.9
Private Financing Domestic*	23.0	19.9	29.3	21.4	-1.9	23.3	24.6	61.1	36.9	60.4	66.3	46.4	-9.6	n.a.	
Banks Long Term*	20.5	16.4	24.0	12.6	-12.1	22.2	17.9	50.6	21.7	52.9	49.0	29.0	-15.6	0.4	
BDB	2.5	3.2	4.6	8.4	8.0	0.9	4.3	7.5	14.1	7.3	14.6	17.4	3.5	-3.7	
Insurance Companies	0.0	0.3	0.7	0.4	2.2	0.2	2.4	3.0	1.1	0.2	2.7	0.0	2.5	n.a.	
Public Share Issues															
Finance Mortgages & Real Estate	8.2	13.2	16.7	20.6	33.0	42.5	40.6	39.8	30.1	36.0	28.3	33.3		n.a.	
Banks	0.1	4.6	3.1	10.4	11.2	15.9	6.8	7.4	0.3	13.4	1.1	5.2	36.1	2.4	
Companies	3.0	5.4	7.3	5.6	9.1	16.2	19.6	17.0	7.9	4.0	9.8	8.5	30.9	51.5	
BMPC	2.5	1.2	1.3	1.3	5.3	6.7	4.7	5.8	4.1	4.9	4.5	7.4	7.3	7.5	
Insurance Companies	2.6	2.0	5.0	3.3	7.4	3.7	9.5	9.6	17.8	13.5	12.9	12.2	16.3	n.a.	
Private Foreign Capital	18.3	61.8	40.7	33.5	20.3	-19.7	46.1	70.9	1.8	-12.8	-49.6	-22.3	-63.3	1.0	
Direct Investment	4.6	44.7	12.4	9.3	18.8	10.1	1.9	14.3	8.2	4.6	-2.9	5.2	10.0	9.2	
Investment in Branches	6.2	2.4	0.3	2.7	4.2	3.1	2.8	15.6	8.0	1.6	0.9	7.1	-4.1	11.2	
Undistributed Earnings	6.6	8.1	1.6	3.0	3.8	2.0	-0.6	-1.2	-0.4	-1.2	-3.3	-3.4	0.5	-3.5	
Long Term Securities	-0.1	-0.1	-0.2	2.3	-5.7	1.7	1.6	-1.6	-0.6	-0.3	-5.7	10.9	-1.3		
Long Term Loan	-0.6	0.2	22.4	11.9	-10.0	-3.4	13.6	82.6	27.6	23.4	1.7	29.7	-21.5	-20.5	
Other Long Term	1.6	6.5	3.9	6.8	1.2	-25.8	26.7	-41.7	-40.0	-40.6	-45.7	-55.2	-59.1	5.0	
Total Financing	79.0	136.9	124.9	134.3	106.3	94.2	215.5	313.0	158.8	248.8	127.5	201.7	148.0		
Discrepancy	88.2	19.3	111.0	104.3	148.2	223.0	208.8	212.0	291.7	172.4	246.4	170.1	275.8		

*excluding mortgages (P) Provisional

SOURCE: Barbados Statistical Service

Table 2

Selected Foreign Payments
($ Million)

	Direct Investment Income	Interest Payments	Management Fees	Royalties
1977	9.6	9.3	3.2	1.8
1978	11.0	5.5	3.6	4.2
1979	12.4	10.6	3.4	5.1
1980	12.2	10.3	5.8	4.1
1981	20.7	14.0	21.9	4.4
1982	15.4	8.0	2.8	4.3
1983	12.3	15.5	4.4	9.4
1984	14.3	25.9	3.7	12.8
1985	9.0	35.8	4.6	10.8
1986	18.4	37.0	8.0	15.4
1987	24.9	26.2	9.0	30.9

SOURCE: Central Bank of Barbados, Balance of Payments 1989