

DeLisle Worrell: Countercyclical policy – what is it, and what are its limitations

Address by Dr DeLisle Worrell, Governor of the Central Bank of Barbados, to the Barbados Chamber of Commerce and Industry (BCCI), Bridgetown, 25 November 2009.

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Members of the Diplomatic Corps
Acting President of the Barbados Chamber of Commerce and Industry,
Mr. Andy Armstrong
Members of the private sector
Members of the media
Distinguished ladies and gentlemen.

This talk offers an opportunity to return to a topic that, as Jewel Brathwaite has picked up, I wrote about in January this year, when I was at the Centre for Money and Finance at UWI, St. Augustine. All the major industrialised countries have tackled the economic crisis with huge government stimulus packages. Why aren't Caribbean countries doing the same? Admittedly some Caribbean countries have relatively high debt ratios, but their debt burdens have been overtaken by countries like the US and UK, in many cases. So why doesn't the Caribbean follow the lead of the industrialised world in countering the down cycle in economic activity with fiscal stimulus?

The notion behind countercyclical policy is simply that government should step up job creation in the public service, and increase income subsidies, in order to compensate for job losses and declining purchasing power in the private sector. Most economists agree that it was the countercyclical policy of the Roosevelt administration in the USA that was responsible for bringing the 1929 Great Depression to an end, even though many argue that the growth of the American economy was firmly restored only after the end of the Second World War. Based on that experience, all major industrial countries are currently engaged in economic stimulus policies which contain a large element of countercyclical spending.

How large is the countercyclical element of current fiscal packages in industrialised countries is a matter of debate. The most conspicuous portion of the US stimulus packages, for example, has been the support schemes for financial institutions rather than the funding of job creation by the federal, state and local governments. What is more, the US has much less generous unemployment insurance provisions than European and Asian economies, and many services such as tertiary education and preventative medicine which are provided publicly in those economies have to be purchased privately in America. Job losses in the US therefore have knock-on effects on the budgets of health providers and universities in the US that aggravate the fall in national income, to a far greater extent than elsewhere in the industrialised world. And the automatic countercyclical triggers such as unemployment insurance payments and other income supplements are much weaker in the US.

Expansionist fiscal policies by the world's largest economies are an essential element for the recovery of the international economy, and it is not an accident that the countries whose governments have been most vigorous in funding job creation from the public purse are showing the most convincing evidence of economic recovery. The workers who find jobs in the design, construction and renewal of public works in turn generate demand for the services of transport, finance, lawyers, engineers, health, education, public utilities and other services. Governments need to borrow to fund the expanded expenditure, but there is a ready and inexpensive source of funding, from investors in search of low risk government securities.

In contrast to largely self-reliant countries like the US, countercyclical government spending in small open economies like Barbados is of limited use, and may have lethal consequences.

In the US each extra dollar of income earned occasions no more than 23 cents of spending on imports. That means that when the US government spends \$10 million to pay wages for new public works, those wage earners spend almost \$8 million on goods and services provided by other Americans, and only a little over \$2 million on imported goods and services. In Barbados it is almost exactly the opposite. Our propensity to import is 76 cents of every dollar. Were the Barbados government to spend \$10 million on new public works, only a little over \$2 million of the money earned would be spent on items such as hairdo's and bus fares, and almost \$8 million would be spent on imports. In other words, countercyclical expansion in the US benefits mostly Americans, whereas countercyclical policy in Barbados benefits foreigners to a far greater extent than Barbadians. (A comparison of average import propensities for the five-year period 2003-2007 in the US and Caribbean countries may be found in the newsletter of the Caribbean Centre for Money and Finance, January 2009, available at www.ccmf-uwi.org.)

What is more, there is nothing that can be done to reduce Barbados' import dependence. Almost everything that supports the quality of Barbadian lifestyles and our high standard of living is imported, or has a high import content. Import substitution activities such as chicken production and the Pine Hill Dairy substitute imports of raw materials for imports of finished goods, because all their feedstocks are imported. Import substitution in Barbados is largely substitution between categories of imports, and it therefore does little to reduce the demand for foreign exchange. A high propensity to import is what economists call a structural feature of small open economies which enjoy a good standard of living, a feature which Barbados shares with similar economies worldwide.

Therefore, the scope for countercyclical government expenditure in Barbados is limited because of its impact through imports on foreign exchange reserves. The maintenance of an adequate level of foreign exchange reserves is a major objective of official policy, because it is the foreign reserves which guarantee the stability of the exchange rate and of the macroeconomy.

At the moment, Barbados' foreign reserves are comfortably above the equivalent of three months of imports, which remains the international norm for countries like Barbados which have an exchange rate pegged to the US dollar. Indeed, an important benefit of Barbados' remarkable record of 34 years of an unchanged peg is that the country has demonstrated that it can maintain a stable exchange rate with far less than the international norm, in terms of foreign exchange. Foreign reserves, it should be remembered, are held in US treasury securities, and are therefore a loan to the US government. It is not only the Chinese and Saudi Arabians who have been contributing to financing American profligacy; Barbadians have also been making a modest contribution. It wouldn't make a lot of sense to take bread out of the mouths of Barbadian mothers and children to add to our funding of the U.S. government, much as they may need the money. (It is a sad irony that relatively poor countries like Jamaica are constrained to hold far larger foreign reserves, in relation to imports, because their exchange rates are prone to devaluation.)

The Barbados government therefore needs to proceed with caution in incurring extra spending because the domestic employment impact is limited, and the additional spending will result in additional import demand. Even though reserves are currently more than adequate, no one knows how long it will be before tourism demand will revive, and until then, it would be wise to proceed cautiously, using the more pessimistic assumptions about the pace and timing of economic recovery in Barbados' main tourism markets. If things turn out better than our assumptions, the country will have foreign resources to allow for new initiatives by government for the diversification of exports and services, but if things do turn out for the worse, the stability of the economy will not be threatened.

Barbados is well positioned to be among the first to benefit from a revival in international resort tourism, whenever that occurs. The country now has a high proportion of tourism product in the top end of the market. Although high net worth individuals were especially hard

hit by the financial crisis, the high income market is expected to be the first to recover. Moreover, Barbados has acquired an enviable profile internationally as being among the most desirable of holiday resorts. I am not quite sure how we did it, but I saw it happening when my wife and I lived in Maryland. When we arrived there in 1998 Barbados was known only to the cognoscenti, but we began to hear the country being mentioned in the media with increasing frequency. Tiger Woods' wedding and Serena Williams' first visit raised our visibility, and Rihanna has of course sealed our reputation. By the time we left Maryland last year, Barbados was a household name, and everyone we met wanted to visit.

The onslaught of the economic crisis has not materially altered Barbados' economic priorities or the constraints which those policies must respect. The economy continues to be driven by exports of goods and services, mainly tourism, which provide the foreign exchange needed to satisfy the country's import demand. It remains the case that policies should be directed to diversification, principally by the exploitation of tourism niches. Tourism will remain the principal engine of growth for the foreseeable future, and we must move ahead of the curve in renewing the product and innovating within the sector, to avoid the stagnation that will otherwise result from a stale product range. International business services, energy and environmental services are other known priorities.

The government and private sector of this country are not short of good ideas for investment in these priority areas. The critical limitation is the capacity for implementation. It is not well known that some years ago the IDB actually cancelled loans that had been approved for Barbados' social and environmental infrastructure, because government failed to get the target projects underway, many years after the funding had been approved. This capacity for swift and efficient implementation of projects, while observing established procedures for accountability and disclosure, needs to be established and strengthened. It is not an overnight process, it is not easy to do, and it will not generate flashy headlines, but it is what really matters.

Barbados' institutional arrangements for making public policy are also a major strength of the economy, that enable the country to cope with the impact of the economic crisis, and to react in a level headed fashion. Barbados' social partnership has now become legend, the subject of articles in learned journals and an example that is often cited by international financial institutions. We know how imperfect it is, but we must not lose sight of its vital importance in giving voice to all the principal agents in the economy. In times of economic difficulty, successful adjustment is possible only if all parties clearly understand the situation, and what are the realistic options for dealing with it.

Barbados also boasts a tradition of well coordinated monetary and fiscal policy, which has served the country well in periods of economic difficulty. My colleagues Harold Codrington, Roland Craigwell, Kevin Greenidge and I have written about the economic crisis of 1991-92, and how the mechanisms for coordination between the Ministries of Finance and Economic Affairs, and the Central Bank, facilitated effective policy making. The Prime Minister has agreed to an upgrade of those arrangements, to take advantage of new communications technology to facilitate the sharing of data and analysis between the economic decision makers in the public sector.

Let me summarise the argument: the government of a small open economy like Barbados can do little to compensate for a decline in output which results from falling demand in the foreign exchange sector. Government needs to temper its expenditure in order to avoid an erosion of foreign exchange reserves, focusing on measures to maintain the competitiveness of tourism and to protect those most vulnerable to the effects of the downturn. Government and the private sector should continue to address the priorities for the medium term growth of the economy: improving the pace of project implementation and pursuing strategies of diversification within tourism, further development of international business services, and new initiatives in energy and environmental services.

Finally, I want to stress the importance of open communication, and the value that the Central Bank places on opportunities such as this to enter into dialogue with the people whose activities all together constitute “the economy”. I am sure you follow carefully the Bank’s quarterly reports on the economy, and I hope you keep track of the economy’s vital statistics, particularly the foreign reserves, which we publish monthly. Both data and analysis are available on the Bank’s website. It has always been the Bank’s policy to empower you to confirm our analysis by checking the numbers yourselves. Occasions such as this luncheon offer you the opportunity to raise questions that you might have regarding how we view the economic performance and outlook, and I am therefore happy to welcome your questions.