Dealing with Balance of Payments Adjustment Problems in Barbados: A Conceptual Perspective

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Abstract

In recent times Barbados has been experiencing potentially serious Balance of Payments adjustment problems, which, if not remedied, could have serious, long term consequences for macroeconomic stability within the domestic economy. To address the current problems, the Prime Minister and Minister of Finance recently announced a series of measures aimed primarily at reducing imports of luxury goods and curtailing credit to the private sector. Against this backdrop, our paper explores the idea of dealing with Balance of Payments adjustment problems in Barbados, from a conceptual perspective. Within this context, our paper addresses two key questions: First, is there a solution to the current BOP problems being experienced by Barbados? Second, if there is a solution, what is it? With respect to the first question, we present clear evidence that suggest there is indeed a solution to the current Balance of Payments problems Barbados is experiencing. We argue that the measures announced by the Prime Minister and Minister of Finance are economically sound from a structuralist perspective, but could only create short-term solutions. Furthermore, the success of the measures depends heavily on moral suasion, and the willingness and ability of Barbadians to comply with the measures. Hence, in relation to the second question, the long term solution to Barbados' Balance of Payments problems requires the revisiting of a policy of Import Substitution that allows for open import competition, but does not involve excessive use of protectionist measures, which would clearly violate current WTO governed rules for free trade.

1. Introduction

In recent times Barbados has been experiencing potentially serious Balance of Payments (BOP) adjustment problems, which, if not remedied, could have serious, long term consequences for macroeconomic stability within the domestic economy. To address the current problems, the Prime Minister and Minister of Finance recently announced a series of measures aimed primarily at reducing imports of luxury goods and curtailing credit to the private sector. Against this backdrop, our paper explores the idea of dealing with BOP adjustment problems in Barbados, from a conceptual perspective. Within this context, our paper addresses two key questions: First, is there a solution to the current BOP problems being experienced by Barbados? Second, if there is a solution, what is it?

To achieve our objectives, the rest of the paper is structured as follows. Section two highlights some of the main theoretical arguments for and against government's intervention to resolve BOP problems, and the policies necessary to effect BOP equilibrium. Section three presents a summary of the contextual framework within which the Prime Minister and Minister of Finance of Barbados considered the measures proposed to deal with the potential BOP problems facing the country. This Section also documents the more important policies proposed by the Prime Minister and Minister of Finance to alleviate the BOP problems. Section four summarises the economic and historical experiences of Barbados and other Caribbean countries that led to the evolution of the pattern of trade and development observed. Section five discusses briefly both the Import Substitution Industrialisation and Outward Orientation Development Paradigms from a theoretical and conceptual perspective. Section six examines the experience of several countries under each Development Paradigm. Section seven highlights some of the failures of Import Substitution Industrialisation that have been discussed and documented in the literature. The final section contains some concluding remarks.

2. Theoretical Perspectives

The discussions in this section of our paper follow closely Ruccio (1991). Most orthodox economists concur on the need to adjust the domestic economy in response to balance of payments deficits arising from inadequate export earnings or excessive imports, or both. However, economists often disagree on the policies prescribed to resolve the balance of payments difficulties. Some economists advocate tighter monetary policy, lowering government deficits, and liberalizing internal and external trade and capital markets; other economists dismiss this market-oriented, orthodox policy package and, instead, argue for increased controls over markets. These different recipes for success derive, in large part, from the use of different economic theories. Both neoclassical and structuralist economists agree that success entails moving the economy to a position of balance of payments equilibrium. However, they disagree about the appropriate policies to achieve such success.

According to neoclassical economists, the need for such policies is based on the persistence of unsustainable external disequilibria. These problems are, in turn, caused by a series of imperfections that prevent external markets from clearing. For example, balance of payments difficulties are tied to, among other things, overvalued exchange rates and the existence of exchange controls. In both cases, the problem is caused by an unwarranted government (or other) intervention that keeps markets from clearing and therefore gives improper market signals to individual economic agents. Without such microeconomic imperfections, macroeconomic imbalances cannot arise—or, if they do emerge stability will reappear as soon as the appropriate individual decisions are taken and market adjustments are made. How, then, can a situation arise where a balance of payments deficit exists? Transitory disequilibria may appear if one of the underlying determinants of the model changes—as a result of an internal or external shock; for example, an unanticipated increase in import prices or a severe drought—and markets have not yet had time to adjust. Once the appropriate adjustments have been made, however, the disequilibria disappear and macroeconomic stability is once again established.

If internal and external balance is automatically restored by individual decisions, persistent disequilibria can only be explained by the existence of barriers to the carrying out of such decisions, that is, market imperfections. Thus, for example, if a government decides to manage the exchange rate "float" by not allowing the full depreciation necessary to eliminate a balance of payments deficit, the resulting overvaluation will prevent domestic factors of production from shifting in the requisite proportions from nontradables to the production of import substitutes and exports. This obstacle will be further complicated by other possible market imperfections such as downwardly rigid wages, trade barriers, capital controls, a government decision to overexpand the money supply to satisfy the demand for real cash balances, and so on. In this sense, maintaining such imperfections can be thought of as quite irrational, since they prevent a country from achieving what it would otherwise be able to achieve, namely, the maximum wealth for its citizens.

The orthodox set of policy measures advocated by neoclassical economists to solve such persistent disequilibria is equally well known and include: balancing the fiscal budget, real wage adjustments, exchange rate depreciation (either by devaluing the overvalued currency or by instituting flexible exchange rates), exchange liberalization, and external trade liberalisation. All of these policies are designed to eliminate the obstacles that prevent individuals from making the appropriate adjustments and to bring government actions in line with the results of allowing markets to operate freely. In other words, in the face of macroeconomic imbalances, policymakers have two choices: (a) do nothing, and let individuals make the appropriate microeconomic decisions; or (b) if market imperfections exist and/or if there is government mismanagement of policy, dismantle market barriers and restrict the government to its role in maintaining free markets and other minimal guarantees of engaging in individual economic activity. Success is indicated when, on the basis of individual decisions, the economy reaches a point of balance of payments equilibrium.

The neoclassical economists' celebration of market-oriented stabilisation and adjustment is grounded, then, in a humanist logic according to which all economic structures can be reduced to individual choice. Macroeconomic results are determined within microeconomic markets, and market behaviors are reflections of (constrained) individual choices. These choices are, in turn, tied to the given preferences and expectations of individual human beings. For example, according to neoclassical economists, the balance of payments is determined by individuals' decisions concerning their willingness to hold stocks of money or interest-bearing assets. Once the individually desired targets are reached, there is no need to adjust their balances any further and external payments equilibrium is restored.

Structuralist economists criticise the neoclassical story and the implied policy of little or no state intervention. They argue, instead, that markets are inherently imperfect stabilisers and that, if left to themselves (that is, without government's intervention), they will not be successful in restoring internal and external balance. Based on this alternative model, structuralists tell a different story both of the effects of orthodox policies and of the kinds of policies that should be adopted in their place. As mentioned above, neoclassical economists often advocate exchange-rate depreciation as a way of correcting a balance of payments deficit. From the structuralist perspective, such a policy is doomed to failure: not only may it not lower the current account deficit (except over the long run, when trade structures become less inelastic, and only in conjunction with other industrial policies); it will probably also cause both increased inflation and recession.

Not surprisingly, this model also leads to an alternative, so-called heterodox policy package. Whereas neoclassical economists focus on free markets, structuralists argue that market imperfections are inherent in real-world conditions and that development policy must contend with them—not magically dispose of them as in the neoclassical story. Thus, structuralist economists advocate increased controls over (imperfect) markets: to overcome sectoral complementarities and trade inelasticities, industrial policies; to orient microeconomic investment decisions in the face of uncertainty, capital controls. From the structuralist perspective, these policies, and not unregulated markets, can ultimately lead to success in combatting balance of payments difficulties.

This alternative approach to success of structuralist development economics can be explained by a structuralist methodology that is as deterministic as its neoclassical counterpart. However, the direction of determination used by neoclassical economists is reversed: structuralists consider individual economic behaviors to be determined by a set of given economic and social structures. In this sense, reference to the "structuralism"—the antihumanism—of structuralist economic theory might be confusing, but that term is probably even more appropriate than many believe.

According to structuralist economists, the macro relationships of an economy are determined not by individual decisions but by a set of "key forces" which governs production, financing, and other economic activities. These economic and social structures include oligopolistic industries (which give rise to markup pricing behavior), institutionally determined wages (tied, in turn, to the existence of surplus labor and/or capital-labor conflict), fixed coefficient production functions, "animal spirits" and uncertainty, and incomplete or poorly articulated credit and transport systems. Given these structures, individuals are prevented from generating full employment, price stability, and external payments balance. Instead the macroeconomy may reach equilibrium at which one or more or any combination of these conditions will not be satisfied. Starting with these structures, structuralist economists argue that the free operation of markets will only generate more unemployment, inflation, and balance of payments difficulties. Markets are therefore a problem, not a solution. Instead, structuralists contend that success lies with another structure: government policies and controls. The government is needed to coordinate and guide individual choices to the point where full equilibrium is reached. The market behavior of individuals is thus determined by the irreducible structures—institutions, power relationships, and so on—of the society in question.

Indeed, there is, of course, a third approach which combines elements of both neoclassical and structuralist stories. In effect, this alternative approach serves to reinforce the two poles of the debate—individuals and structures, free markets and government controls. Like the structuralists, the economists of the middle position observe the possibility of less-than-full employment equilibrium and balance of payments deficits in the absence of government intervention. However, like their fully neoclassical counterparts, they argue that violating the "fundamentals" of markets will ultimately prevent the macroeconomy from reaching a sustainable full equilibrium.

Depending on the time and place, the advocates of this middle position move back and forth between neoclassical markets and structuralist government interventions. It would seem that their sights are set on a perfectly neoclassical world in which individuals operating through free markets could maintain internal and external balances, but that the advocates cannot quite imagine the immediate elimination of all market imperfections. Thus, they appear to believe in a kind of managed transition from a short-run structuralist world to a long-run neoclassical one. This middle position is thus based on an ever-changing compromise between humanism and structuralism. At times, the tendency to reduce all economic phenomena to human nature is apparent; at other times, given economic and social structures play a significant role.

3. The Context and the Proposed Solutions

3.1 The Context

At present, the major difficulties facing Barbados with respect to its balance of payments position relate directly to the country's external trade balance and international reserves position. Hence, the main thrust of the Government of Barbados' economic policy is to deal with certain structural trends in the country's external trade and its international reserves position, both of which were sufficiently worrisome to warrant the attention of the Government. It is within this context that by the Prime Minister and Minister of Finance proposed several solutions to the current balance of payments problems facing the economy. But, what exactly are the sources of the problems that are hurting the external account?

According to the Prime Minister and Minister of Finance, Barbados' current balance of payments problems can be linked to several factors including the inheritance of a weak export structure that relied too heavily on preferential access of agricultural commodities to the European Market; trade liberalisation efforts under the auspices of the World Trade Organisation; the implementation of the CARICOM Common External Tariff (CET); the huge and rapidly growing import Bill; the significant reduction in revenue generation from offshore financial services transactions and international business; the Organisation for Economic Cooperation and Development harmful tax competition that not only put the international business and financial sector's development on pause, but threatened the very survival of the sector; the consolidation of all of Barbados' indirect taxes into one Value Added Tax; and China joining the World Trade Organisation and, with it, went most of the world's production of textiles.

Additionally, the Prime Minister and Minister of Finance inferred that the external problems that the Barbadian society is facing have also to do with certain macro economic forces affecting the country. He lamented the fact that Barbadians are spending too much in relation to the country's earning capacity simply because they have easy access credit. Therefore, every time there is a surge in credit creation in excess of the growth in liquid assets in the financial system, that major addition to spending power puts additional pressure on the country's international reserves.

The net effect of these developments was a reduction in import duties from 45 percent during the 1980s to 20 percent at present. That reduction in duties lowered the cost of extra-regional imports as well as increased the competitive position of extra-regional imports in Barbados. Overall, the country continues to witness an unsustainable demand for imports. Consequently, the Prime Minister and Minister of Finance observed that in 2004 Barbados' imports increased by almost $450 million and by 17 per cent; credit in Barbados extended to the banking system, largely to the distributive sectors and to private individuals, increased by $650 million, a 17 percent rise. The Prime Minister and Minister of Finance concluded that a series of measures would have to be instituted to control the growth of credit in the economy, because it is credit, above all else, that is causing the growth in Barbados' imports.

In essence, therefore, what Barbados faces is the twin problem of surging imports and weak export performance. The performance of the tourism sector vis-à-vis the generation of a tremendous amount of foreign exchange is insufficient to compensate for the growing demand for imported consumer goods and the inadequate performance of other traded sectors of the Barbadian economy. To counteract these difficulties, the Prime Minister and Minister of

Finance proposed several measures aimed at curtailing imports of consumer goods as well as boosting revenue generation that can, in turn, be injected into boosting the country's productive capacity and, by extension, export potential.

3.2 Proposed Solutions

Within the context of the balance of payments difficulties documented in the section above, the Prime Minister and Minister of Finance of Barbados proposed several measures aimed at resolving the external imbalance, especially on the current account, so that the economy can return to a sustainable external position. First, the Central Bank of Barbados has been given the mandate to tighten credit by increasing interest rates as well as by varying the reserves requirements to make sure that credit becomes more expensive and harder to get, and to restrain the extent to which credit creation undermines Barbados' capacity to pay its way in the world. Indeed, the objective of this proposal is to put a line on credit creation for both public and private purposes if the economy is to restore external balance. However, the Prime Minister suggested the need for more credit to be directed towards expansion in agriculture and tourism as well as other productive purposes rather than to the distributive sector and for personal use to purchase imports.

Second, measures aimed at creating new capacity and bringing new incentives to bear to stimulate desirable change with respect to exports. Towards this end, the Prime Minister and Minister of Finance proposed the creation of a dedicated Export Promotion and Marketing Fund to assist in boosting exports. According to the Prime Minister and Minister of Finance, the best way to pay for export development is to tax other people's imports and use the money from taxing other people's imports to pay for Barbados' export development. This initiative is justified on the grounds that Barbadians are consuming $2.8 billion worth of imported goods, and in fact, the rate of consumption is increasing at $0.5 billion a year. The proposed measure to resolve this problem is a 3 percent excise tax on extra-regional imports of consumption goods for 18 months. Goods needed for investment inputs, company operating under incentives, and the hotel industry are all exempted from the tax. The anticipated effect of this measure is to curb the importation of foreign goods and encourage more sales of domestically produced goods. Hopefully, the net result of this measure would be the enhancement of domestic production capacity to expand Barbados' exports, and the building of distribution relationships with Barbadians and the domestic economy.

Third, the Prime Minister and Minister of Finance noted that an aspect of Barbados' over consumption, and an area in which the country's import Bill has been growing too fast, has been the importation of motor vehicles. In this regard, the Prime Minister and Minister of Finance proposed a change in the Excise Tax on motor vehicles. For vehicles with 1800 cc or a chargeable of $45,000 or less, no change in the Excise Tax, no change in the price. Cars above 1800cc, and above $45,000 will witness an increase in the Excise Tax from 93 percent to 120 percent.

Fourth, lorries that are 5 tonnes in weight or over will now pay an Excise Tax of 10 percent of their value. In addition, the environmental levy on used cars would move from $150 per car to $2,000 per car.

Indeed, the Prime Minister and Minister of Finance pointed out that the revenues from the 3 percent excise tax on extra-regional imports on consumer goods, the excise tax on motor vehicles over 1800 cc and a chargeable value of $45 000, the new excise tax on lorries five-tonnes and over, and the environmental levy on used cars, are not going to go into the general revenue to be used for general purposes. Instead, these funds will be credited to the Export Promotion and Marketing Fund, which will be administered by the Enterprise Growth Fund.

There will also be a committee of officials to allocate how these funds are raised. Also, some of the funds will be accessible to the private sector to help them to put in place export production capacity.

4. The Economic and Historical Experiences of Barbados and Other Caribbean Countries

The current economic landscape in Barbados is to a large extent a reflection of the historical relationship between that country with Europe and North America. This relationship has shaped the economic structure of the country and ultimately dictated the pattern of production and trade. Indeed, this colonial and historical relationship between Barbados and Europe, particularly the United Kingdom, means that the economic performance of Barbados is inextricably linked to the preservation of this relationship.[1] Furthermore, the benefits to be derived from this relationship depend on a number of factors (such as stability in the prices of exports to Europe, favorable terms of trade, and continued access to preferential arrangements). Notwithstanding the benefits expected from existing relationships with Europe, Barbados, like other Caribbean countries, nonetheless pursued development strategies that involved some degree of industrialisation. In this respect, two distinct periods in the country's economic development can be identified: the 1960s and 1970s, and the 1980s to present.

The development paradigm followed by Barbados and other Caribbean countries were consistent with the views expressed by Nobel Prize winning Caribbean Economist, Arthur Lewis. Undoubtedly, Lewis (1950, 1954) are the early attempts at constructing an economic model or theory specific to the problems of the Caribbean. Given the period in which he wrote, it is no surprise that Lewis' ideas paralleled classical thinking. To a large extent, his views reflected some degree of dissatisfaction with the vast deterioration in the economic and social conditions

[1] Blackman (1991) discussed issues relevant to this relationship in the wider Caribbean context.

of Caribbean countries and the manner in which the colonial authorities handled the developments. To arrest these declining fortunes and begin the process of economic transformation of Caribbean economies, Lewis advocated a strategy of industrialisation, mainly in light manufacturing, to transform Caribbean countries economically. This strategy, Lewis argued, was the only way that these economies could solve their main problems of overpopulation and poverty. His strategy called for the insertion of foreign enterprise and capital or investment into Caribbean economies to take advantage of cheap labor in the traditional agricultural sector and to manufacture for metropolitan markets. In terms of policy, Lewis prescribed: (a) Export-based industrialisation for the regional Caribbean economy, (b) Inviting foreign capitalists to invest in the domestic economies, and (c) Offering tax and other incentives to encourage overseas investment in the countries. Evidently, all of Lewis' proposals were implemented in Barbados and other Caribbean countries, to varying degrees. To some extent, these policies worked relatively well for Barbados and other countries in the Caribbean region.

As brilliant as Lewis' ideas were, they received severe criticism, mostly from the Plantation School.[2] Plantation economies of the Caribbean were said to have sufficiently special and unique historical, structural, and institutional features as to require a new analysis that makes these features central to the model. The central hypothesis of the plantation economy model is that the plantation legacy deprived the region of internal dynamics, and involved patterns of income distribution that discriminated against economic transformation. Hence, unlike Lewis' model of industrialisation through attracting foreign direct investment and promoting exports, the plantation model is one of internally propelled growth and development. In terms of policy prescriptions, the plantation economy model proposes that production be reorganised around the domestic economy, with the local sectors becoming the target for investment and long-term

[2]For some of the criticisms levied against Lewis and an in-depth exposition on the plantation school, see Beckford (1972), Best (1968), and Thomas (1968).

capital accumulation. A policy of import substitution industrialisation (ISI) was favored. This paradigm dominated development policy in Caribbean countries during the 1960s and 1970s as well as the early 1980s.

Faced with macroeconomic problems in the 1980s[3] and spurred on by the International Monetary Fund (IMF) and the World Bank, many Caribbean countries abandoned their inward-looking strategy of industrialisation in favor of an outward-oriented policy that intended to promote growth through export expansion. This strategy promoted exportation of processed products, semi-manufacturers, light manufacturing, and nontraditional agricultural commodities (rather than continue to focus on the export of a few major unprocessed primary products). In essence, import substitution industrialisation was replaced by an outward-oriented development strategy (Thorpe, 1997; and Weeks, 1995).

Beginning in the 1980s, the continued poor economic performance of developing countries (and the evolution of development thought in concert with contemporary economic events) increasingly questioned the wisdom of the ISI paradigm. The new consensus that emerged argued that an outward-oriented approach that focused on trade in general, and exports in particular, should be pursued. The basic argument supporting this view was that openness to foreign competition and capital and elimination of export biases would engender structural change in accordance with the dictates of comparative advantage.

As the outward-oriented paradigm gained favor with the United States Agency for International Development (USAID) and the World Bank, access to development funds became increasing dependent on adopting polices consistent with this approach. During the period 1978-

[3]Some of the economic problems of the 1980s included reductions in gross per-capita investment, deterioration in physical and human capital, rising levels of malnutrition, rising levels of debt, sharp contraction in private capital inflows, an increase in net outflows of capital, weak economic structures, and inappropriate economic policies (Wilson, 1992). The 1970s oil crises significantly aggravated these economic problems. For a detailed discussion of the oil crises see Lee et al. (1990), Fleay (2000) and Odell (2001).

1988, the Organisation for Economic Cooperation and Development (OECD, 1992) documented the huge amount of resources in the form of official/overseas development assistance (ODA) to the Caribbean from various bilateral and multilateral donors including the U.S.,[4] Canada, the United Nations Development Program (UNDP), and the IADB. Net ODA disbursements to the Caribbean from all sources, at 1987 prices and exchange rates, totaled $572 million in 1978 and $509 million in 1988 (OECD, 1992, p. 98-99). Agriculture benefited tremendously.

Thus, Barbados, like many other Caribbean countries, had little choice but to move in the direction of outward-oriented policies, despite continued skepticism regarding the efficacy of those policies. This state of affairs led to the outward-oriented paradigm being identified as the Washington Consensus.[5] The Washington Consensus seemed opposed to all forms of import protection.

Over time, and as attempts to adopt policies consistent with the Washington Consensus intensified, the outward-oriented paradigm came under increasing scrutiny and criticisms in a number of areas. For instance, while the benefits of nontraditional exports continue to be acknowledged, understanding the complex interactions among exports, technology transfer, and domestic learning remained elusive. It is clear, however, that exports alone do not create the endogenous learning processes critical to sustained economic growth and development.

Despite the shift in paradigm from ISI to outward orientation during the early 1980s, Barbados and other Caribbean countries are still struggling to realise their full economic potential, and maintain BOP and macroeconomic stability. Hence, the debate over the choice between close or open economic policies continues unabated with no clear answers in sight.

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[4]The U.S. efforts towards boosting agricultural export expansion from the Caribbean was strongly supported by the passage of the Caribbean Basin Economic Recovery Act (CBERA) in 1983 and its successors, the Caribbean Basin Trade Partnership Act (CBTPA). The CBTPA expanded duty-free access to the U.S. market granted under the original CBERA and provided near NAFTA parity to eligible beneficiaries.

[5]John Williamson is credited with the creation of the concept know as the Washington Consensus.

5. Development Paradigms

Against this backdrop, the underlying purpose of our paper is to determine whether or not an Import Substitution Industrialisation (ISI) Strategy can be a viable option for Caribbean countries within the context of a more globalised and liberalized trading environment. The analysis is being conducted from a theoretical and conceptual basis, drawing on some of the practical lessons learned from ISI, documented in the literature. Hence, the objectives of our paper are two-fold: (i) To explore issues pertaining to import substitution industrialisation and outward oriented development paradigm and (2) To determine whether the ISI Strategy can in fact be a feasible development paradigm within the context of the Caribbean.

The major issues or questions addressed in our paper are: (1) Whether or not ISI can be a prudent Development Strategy that Caribbean countries could pursue? (2) Was the failure of the ISI Strategy in the early 1980s the result of a bad strategy or poor implementation on part of the governments? (3) Should the issue of ISI be reconsidered within the context of Caribbean type economies?

Several useful articles and books have been written on Caribbean development strategy including McAfee (1991), Payne and Sutton (2001), and Rodriguez (2001). However, throughout this section, the discussions on Import Substitution Industrialisation and Outward Orientation draw heavily from Liang (1993) and Bruton (1998).

Until the past twenty years or so, two primary allocation mechanisms competed for the world's philosophical crown of "best:" (1) market-based capitalism and (2) central planning. The argument for capitalism is rooted in the notion of the invisible hand and gains from specialization formulated by Adam Smith over two hundred (200) years ago. The basis of this notion was that individuals left to pursue self interest, would evolve a pattern of specialization in accordance with their individual talents and desires (comparative advantage). Through market exchange it was argued the most efficient allocation of resource and consumption would emerge.

While these ideas remain the philosophical foundation supporting the efficiency of markets, it was not long before it became apparent that the outcome of unfettered self-interest and market forces could create significant social issues in terms of the resulting ownership of resources and the equity with which the income from economic activity was distributed. From such concerns, central planning evolved as a competing allocation mechanism. At its most basic level, virtually all decisions concerning who should produce what for whom were placed into the hands of government central planners, usually in the form of "five-year" plans. While few countries embraced central planning in the extreme, many of these principles were manifest in various from of social capitalism that witnessed heavy involvement of the State in key areas of economic activity.

The evolution of development paradigms over the past half-century has largely mirrored the debate over markets versus central planning as the most desirable form of economic organization. In the 1950s, the prevailing view was under development was rooted in the economic structure of production, primarily the predominance of agricultural and mineral activities, and the inability to benefit from trade because of this structure. Thus it was argued that countries must alter their structure in order to industrialize. The initial beliefs on how this was best accomplished evolved into the import substitution industrialisation paradigm.

6. Countries Experience

6.1 Import Substitution Industrialisation

Import Substitution Industrialisation, first introduced in Latin America in the 1950s as a flaccid response to acute foreign exchanges shortages and the interruption of world trade, particularly imports, brought about largely by the 1930s great economic depression and World Wars I and II, may be viewed from two different perspectives: (i) as a historical phenomenon, an ex post definition and (ii) as a deliberate strategy, an ex ante concept (Liang, 1993). As a historical phenomenon, ISI refers to the general practice of producing goods and services locally that would substitute for those previously imported. As a deliberate strategy, ISI represented the basic policy prescriptions for generating structural change within an economy and a mechanism for facilitating higher degrees of industrialisation.

Myrdal (1957), Nurkse (1961) and Prebisch (1964) are recognized as the early proponents of ISI in Latin America and the Caribbean (McIntyre, 1995). According to McIntyre (1995), these development economists contended that the prospects for Less Developed Countries' export expansion were poor because of unfavorable external demand and domestic supply factors. Developing country exports did not expand as fast as the world average. Three factors accounted for this. First, developing country exports may be concentrated on commodities for which the world demand is growing more slowly than that of the world average for all commodities. Second, the market distribution of developing country exports may be biased toward markets that are stagnant relative to those in which the demand is growing faster than the world average. Third, developing countries may be less competitive than developed countries.[6]

ISI was predicated on the idea that developing countries (the South) must protect themselves from imports from industrialized countries (the North) and place emphasis on

[6]See Liang (1993) for further discussions on these factors from the perspectives of both neoclassical and development economists as well as details on the major arguments in favor of ISI - arguments such as the infant industry, external economies and the linkage effects, and capital accumulation.

developing manufacturing activities that would foster structural economic change. Three key developments in the 1950s influenced economic thought and lead to the ISI paradigm: First, a huge distrust of the free market, a major legacy of the Great Depression. The free market could not solve the development problems facing many developing countries. A general lack of confidence that markets alone would generate the required structural transformation for developing countries prevailed. Additionally, the pitfalls of central planning had yet to be realized and the apparent success of the Soviet Union and India in pursuing capital- intensive industrialisation held great appeal. In short, large-scale comprehensive planning, rather than the market, was assumed to be the appropriate instrument… (Bruton, 1998, p.907)

Second, the importance of capital formation. Considerable attention was placed on the fact that countries in the North had much higher capital labor rations that those in the South. As a result, polices designed to facilitate capital formation evolved. Such policies included over-valued exchange rates, and various forms of protection including tariffs, import licensing and exchange control. In some sense, distortions built upon distortions. Non-durable consumer goods rather than capital good tended to be the most protected as it were believed they could be best produced domestically due to lower technological requirements.

Third, a desire to replicate the North. There was considerable belief that the easiest way to attain the affluence of the countries in the North was to replicate them. Thus emphasis was placed on capital formation and industrialisation. One key result of this strategy was that institutions, organizations and values of the traditional sector were essentially pushed aside if they impeded this process. (Bruton, 1998, p. 909)

Beginning in the 1980s, the poor economic performance of developing countries continued and the evolution of development thought evolving in unison with contemporary economic events increasingly questioned the wisdom of the ISI paradigm.[7] Faced with macroeconomic problems in the 1980s[8] and spurred on by the International Monetary Fund (IMF) and the World Bank, many Caribbean countries abandoned their inward-looking strategy of industrialisation in favor of an outward-oriented policy that intended to promote growth through export expansion.

6.2 Outward Orientation

The new consensus that emerged following the perceived failure of the ISI argued that an outward oriented approach that focused on trade in general, and exports in particular, should be pursued. The basic argument supporting this view was that openness to foreign competition and capital, and elimination of export biases would engender structural change in accordance with the dictates of comparative advantage.

The origins of the outward orientation paradigm seem to have evolved from the strong economic performance of Taiwan and the Republic of Korea during the1960s. These two countries exhibited rapid growth in both GDP and exports, especially non-traditional products. The fundamental question regarding their economic performance was: how were these two countries able to emerge from a decade of import substitution policies to suddenly become able to expand exports at such a high rate? (Bruton, 1998, p. 921)

The answer appears to be related to a combination of a rapid increase in world trade in combination with an accumulation of physical and human capital that occurred in these two countries dating the first half of the 20th century when they were under Japanese rule. In essence,

[7]See Hope (1986) for an interesting analysis of the costly illusion of industrial growth inherent in the import-substitution strategy, especially for small countries like those in the Caribbean.

[8]Some of the economic problems of the 1980s included reductions in gross per-capita investment, deterioration in physical and human capital, rising levels of malnutrition, rising levels of debt, sharp contraction in private capital inflows, an increase in net outflows of capital, weak economic structures, and inappropriate economic policies (Wilson 1992). The 1970s oil crises significantly aggravated these economic problems. For a detailed discussion of the oil crises see Lee et al. (1990), Fleay (2000) and Odell (2001).

the Japanese had created a physical, economic and institutional environment in these two countries that enabled them to respond to opportunities in international markets.[9] Krueger (1995) noted: *It is widely recognized that an outward oriented trade strategy cannot succeed without development of infrastructure (ports, roads, railroads, electric power, communications), increasing educational attainment, and a number of other policies conducive to growth. (p. 23)*

During the 1970s, it also became increasingly clear that government policies were the root causes of significant distortions and market failures. A significant source of distortions arose from rent seeking as firms learned that it was profitable to devote resources to obtaining favorable policy outcomes and rights (for example, import licenses). Such activities made clear the notion of governments as independent entities that acted solely in the national interest and which could be trusted to address market failure was perhaps erroneous. Instead government began to be viewed as having its own agenda, seeking to maximize its own welfare, and unable and unwilling to take a disinterested and informed stand on economic matters. If government profited from being the government, then it was unlikely to minimize itself. (Bruton, 1998, p. 924-925)

There were several fundamental lessons learned from the examples of Taiwan and Korea. First, there were significant benefits to strong export performance including: (1) employment generation, (2) exploitation of economies of scale, (3) more favorable balance of payments, (4) efficiency gains associated with foreign competition, and (5) enhanced technology transfer. Second, the role of government was recast from one of active planning to take a more minimal

[9]Demas (1991) also noted the success of some East Asian countries like South Korea, Taiwan, Hong Kong and Singapore. He related their success in exports to the high degree of competitiveness of many manufacturing and services' firms from these countries, allowing them to penetrate foreign markets with high quality products at competitive prices. He linked this competitive edge to the level and quality of training of the workforce and the use of technology in production.

role allowing market forces to guide economic activity and structural change.[10] From this perspective, a new orthodoxy based on outward orientation and minimal government emerged. The pillars of this outward oriented paradigm included return of confidence in the markets, commitment to the export of non-traditional products, elimination of price distortions, privatisation of public firms, encouragement of private foreign investment, and maintenance of price level and balance of payments stability.

Several important things were not, however, included in this paradigm. Among the more important exclusions were recognition of the difficulties in the transfer of technology and knowledge, importance of learning by government and private firms, fundamental role of agriculture, and significance of initial conditions especially the role history and institutions.

7. Failures of Import Substitution Industrialisation

Perhaps the most critical aspect of the ISI is not its philosophical basis and validity, but rather the manner in which policies were implemented. There were essentially three primary implementation issues associated with ISI paradigm; namely, how to provide the requisite levels of protection, how to increase savings and investment, and how to undertake the planning process. Perhaps planning is the most important of the three.

In the 1950s, planning was widespread. By the 1960s, virtually every developing country had a plan. Indeed, many international organizations tied development assistance to the existence of such plans. One particularly important outcome of the manner in which these plans were implemented was that agricultural sectors were effectively penalised through various forms

[10]See Stone (1992) for a very good discussion of the role of government in an economy driven by private sector dynamism, market forces, and a system of liberalized economic management, within the context of Caribbean countries.

of price controls and other implicit forms of taxation. The external economic effects of a poorly performing agricultural sector were not adequately appreciated.

By the 1970s, evidence on the impact of ISI policies began to accumulate and suggested that the anticipated results had not been realized. Liang (1993) cited Balassa (1971) and Bhagwati and Kruegar (1973-1976) as studies that provided evidence of the negative effects of ISI on economic performances in several developing countries including Argentina, Chile, Colombia, Egypt, Ghana, India, Mexico, South Korea, Taiwan and Turkey. The studies looked at the welfare effects of various trade barriers but did not account for potential indirect dynamic gains from protectionism. Further, Liang (1993) noted the World Bank, in a 1993 study of trade policies of the 1970s in thirty-one (31) countries, found that per capita GDP growth was lower in countries where government policies supported higher distortions of prices.

Bruton (1998) offered several lessons learned from two decades of pursuing ISI policies. His more important observations include the notion that global post-war economic boom tended to undermine the argument that developing countries could not export, economic agents were more responsive to price incentives than policy makers believed a priori, the model used to determine desired investment rates were proving to be of little benefit, physical (central) planning could not avert economic bottlenecks and misallocations, imports rose faster than expected and economic independence declined rather than increased, it was increasingly recognized that capital accumulation alone was not sufficient for sustained economic growth, the transfer of knowledge (technological, administrative, marketing etc.) was much more difficult and complex than envisaged in the 1950s, and endogenous learning processes were not emerging. Indeed, pursing ISI policies to alter economic structures did not change the capacity of participants to learn and accumulate knowledge.

8. Summary and Conclusion

Basbados' abandonment of ISI, and subsequent adoption of an outward oriented development paradigm in the mid-1980s, was consistent with the fact that the outward oriented paradigm had gained tremendous favor with the U.S. Agency for International Development (USAID), the IMF, and the World Bank. Indeed, access to development funds became increasingly dependent on adopting polices consistent with the outward oriented development strategy. Thus, Barbados, like many other developing countries throughout the Caribbean and Latin America, had little choice but to move in the direction of outward oriented policies despite continued skepticism regarding the efficacy of those policies. This state of affairs led to the outward orientation paradigm being identified as the Washington Consensus.

While the benefits of comprehensive adoption of an outward orientation strategy seems clear, the emergence of the Asian Tigers in the mid-1980s narrowed the original scope of the outward orientation paradigm to focus primarily on export dynamism, leading to the commonly used phrase "export-led growth." The phrase is unfortunate for two reasons. First, it places too much emphasis on exports as a source of growth as opposed to the broader set of polices associated with an outward orientation. Secondly, it suggests that the problems with the ISI paradigm were not so much a matter of distortions as a matter of anti-export bias.

As time has passed, and the attempts to adopt policies consistent with outward orientation proceeded, the paradigm came under increasing scrutiny and criticism in a number of areas. While the benefits of nontraditional exports continue to be acknowledged, understanding the complexities of the interaction between exports, technology transfer, and domestic learning remains elusive. It is clear, however, that exports alone do not create the endogenous learning processes critical to sustained economic growth and development.

Arguments supporting the outward orientation seem to imply that countries could leapfrog from one level of technology to another. However, the reality is that technology transfer is a long-term process that requires concentrating on fundamental issue such as entrepreneurship, institutions, and social values. The long-term nature of technology transfer and the need to generate domestic learning also have implications regarding imports, although the Washington Consensus seems to oppose all forms of import protection. However, if one acknowledges that the problems with the ISI were related to the governments' implementation and distortions, and that technological leapfrogging is not possible, then, some forms of import protection are necessary. The key challenge is to create measures that facilitate learning rather than "making life easy" for domestic firms.

Perceptions as to the role of Government have changed considerably. Clearly, it is generally accepted that government cannot effectively undertake significant planning activities and that markets should, by and large, guide structural transformation. However, to merely say the role of government should be minimal is not very illuminating or useful. Ultimately, the role that government should play in fostering economic growth and economic development is country specific, dependent on institutions, culture and history. As Bruton (1998) noted, *the crucial question confronting government is: how can a government learn, not how can it be minimized* (Bruton, 1998, p. 931).

Bearing in mind the preceding presentation, import substitution is clearly not the solution for all ills of underdevelopment. But neither is it a policy that deliberately wastes resources in poor countries. Notwithstanding its limitations, import substitution does appear to be a useful development strategy, which can redound to the benefit of small, open economies like those in the Caribbean, if accompanied by appropriate subsidiary policies. Unfortunately, it is difficult to argue that other growth strategies are inherently less liable to errors in policy and implementation.

The practical implications of a more open process are that the less developed countries will be invaluably led to even newer directions of manufacturing activities as further changes in demand and factor costs take place. Indeed, this idea is recognition of the fact that cumulative changes in production structures in individual developing countries will take them into production of manufactures of increasing complexity within their own borders. The important condition is that the structure of international trading relationships must remain an open framework capable of providing the group of less developed countries with possibilities of initiating new lines of manufacturing in addition to the traditional ones. It must avoid the counter productive strategy of relegating to the less developed countries a handful of manufacturing activities based on current conditions of production, and thus aborting the future course of their development."

Finally, and within the context of the detailed summary presented in the preceding paragraphs, let us answer the two questions posed in the introductory section of the paper. The arguments presented in our paper clearly suggest that there is indeed a solution to the current Balance of Payments problems Barbados is experiencing. We argue that the measures announced by the Prime Minister and Minister of Finance are economically sound and consistent with the structuralist approach to solving balance of payments difficulties. However, we argue that the measures may only create short-term solutions. Furthermore, the success of the measures depends heavily on moral suasion, and the willingness and ability of Barbadians to comply with the policies announced by the Prime Minister and Minister of Finance. Hence, the long term solution to Barbados' Balance of Payments problems requires the revisiting of a policy of Import

Substitution that allows for open import competition; but does not involve excessive use of protectionist measures, which would clearly violate current WTO governed rules for free trade.

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