Small States Face Big Challenges

BY K. DWIGHT VENNER

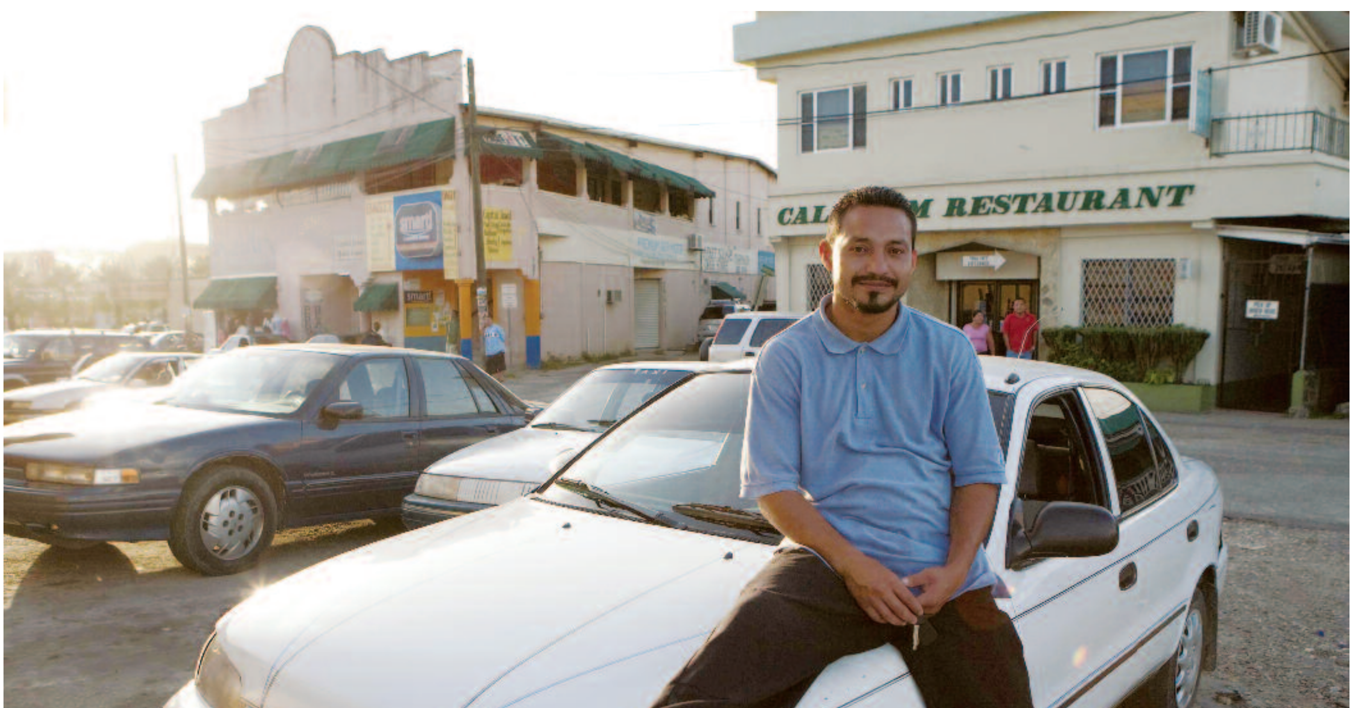
Whether country size matters for economic prosperity depends on a country's degree of economic integration with the rest of the world.
—Alesina and Spolaore, *The Size of Nations*

THE CURRENT GLOBAL FINANCIAL and economic crisis is having an enormous impact on all of the members of the international community regardless of their size or stage of development. Nevertheless, the impact can differ considerably, both in reality and perception, depending on its scale relative to the overall size of the particular state, as well as the government's financial capacity and ability to deploy a range of policy instruments.

This article is organized as follows. First, it defines and identifies small states. Second, it sets out the economic features that are associated with such states and that influence the impact of the crisis. Third, it presents as an example, the case of the Eastern Caribbean Currency Union (ECCU)[1] and its response to the crisis. Finally, it puts forward a view on the role of the international community in assisting small states to prepare for and mitigate the impact of such crises.

What is a small state?

SMALL STATES ARE[2] DEFINED as those with populations of less than 1.5 million people. The World Bank has forty-eight such states in its current membership. These states are located in Africa (11), the Caribbean (12), Asia–Pacific (15), and other regions (10). They have varying geographic characteristics. Some are completely landlocked, while most are islands. Some are geographically distant from major regional centers



A taxi driver in Belmopan, Belize, waiting for customers.

of development (Pacific) while others are closely connected; both conditions have their advantages and disadvantages. Some have valuable natural resources such as oil and diamonds, while others have little.

Small states suffer from three major handicaps:

- Diseconomies of scale in production, marketing, distribution, and public administration;
- Exposure to high levels of risk because of small populations and limited physical space; and
- Limited scope and capacity for negotiating with larger states and private sector entities.

Economic factors

SMALL SIZE TENDS TO LEAD toward concentration of economic activities resulting in near monopolies or oligopolies. Exports are highly concentrated and imports highly diverse, giving them little room for price setting on either front. In short, they are price-takers.

Small economies are highly open to external trade, linking them very closely with the fortunes of the international economy. The scope for their development therefore lies in two directions: deeper integration into the global economy, and concentration on those activities in which they have a relative comparative advantage that, with some effort, could be turned into a competitive advantage.

Those countries that possess neither oil nor diamonds have gravitated toward two activities—tourism and finance. These sectors, however, are inextricably linked to the global economy, and have been greatly affected by the crisis.

There has also been a dramatic decline in foreign direct investment in the tourism sector which, in turn, affects activity in the construction sector—a major contributor to employment. Small states also have large segments of their population living abroad who contribute to workers' remittances which have also been affected by the current crisis.

Empirical studies have indicated high levels of income and output volatility in small economies due to external shocks. Also noted are the lack of technical skills and institutional arrangements to manage such shocks.

The food and energy crisis which immediately preceded the current crisis had an adverse impact on small states and lowered their capacity to deal with the current crisis. The fact is that the current crisis is just the latest and most intense of a number of such events dating back to the demise of the Bretton Woods arrangements in 1971. The period since then can aptly be described as the Age of Volatility.

These financial crises seem to have become more virulent with the passage of time, and have occurred with increasing frequency. The Asian crisis, which had a worldwide effect, put pressure on the other area to which small economies had gravitated, that is, offshore finance. In an effort to design a new financial architecture a whole raft of standards and codes was developed, and a particularly stringent approach was taken to curtailing the activities of offshore financial centers.

The same situation is occurring again as the OECD is now focusing its efforts on the offshore sector. This sector is therefore losing business because of the melt-down of the financial sector in the United States and Europe and the prospect of more restrictions in the future.

The situation with the offshore financial sector raises some interesting and important issues for the international community, particularly the OECD, in the post crisis era.

At present, it would appear that these services are supplied at competitive prices by many offshore centers located in small economies that have few alternative economic activities. If we assume that there are appropriate and effective measures to combat money laundering, tax evasion, and terrorist financing in all countries and that the demand for such offshore services is still extremely large—a distinct possibility given the fact that the movement and trading of financial instruments and services across borders far exceeds that of goods—then this activity constitutes a world market which should be accessible to all countries once the necessary regulatory safeguards are in place.

How did ECCU respond?

THE EASTERN CARIBBEAN CURRENCY UNION (ECCU)[3], with a population of approximately 600,000, has been severely affected by the crisis directly and by the collateral impact caused by the collapse of a regional insurance conglomerate because of imprudent investments in the U.S. and the fallout from the Securities and Exchange Commission (SEC) charges against the Stanford Group of Companies.

The scale of the direct impact of the crisis on the ECCU economies can be seen from the decrease in inflows of tourism receipts and foreign direct investment which have accounted for, on average, 28 percent and 23 percent respectively of GDP in the last three years. Travel receipts fell by 2.5 percent ($80.3 million) in 2008, in contrast to a 3 percent increase in 2007; while foreign direct investment inflows contracted by 29 percent ($1 billion) in contrast to an increase of 14.6 percent in 2007. This has had a negative effect on the central governments' finances and debt. In particular in 2008 the central governments realized a current account surplus of $77.5 million (0.6 percent of GDP) substantially below that of $303.2 million (2.5 percent of GDP) in the previous year; while their total outstanding debt rose by 2.4 percent to $9.3 billion (73.2 percent of GDP).

The ECCU countries, which are united by an integration arrangement through the Treaty of Basseterre (1981) and by a common currency and central bank through the Eastern Caribbean Central Bank (ECCB) Agreement (1983), have responded at both the country and currency-union levels by invoking the provisions embedded in the articles of both treaties.

The Organization of Eastern Caribbean States (OECS) Authority and the ECCB Monetary Council, the highest decision-making bodies of both arrangements, have intervened in both the banking and insurance sectors to take over and restructure ailing institutions. They have also accelerated the process of implementing a comprehensive regulatory and supervisory regime to meet the current and future challenges.

APPENDIX I: COMPARATIVE INDICATORS FOR SELECTED SMALL STATES—2007

AFRICA

COUNTRY	POPULATION (thousands)	POPULATION (1=smallest)
Cape Verde	441	27
Comoros	558	30
Djibouti	632	32
Equatorial Guinea	457	29
Gabon	1,230	42
Gambia, The	1,303	44
Guinea-Bissau	1,199	41
Mauritius	1,186	40
Sao Tome & Prin.	148	16
Seychelles	81	10
Swaziland	1,045	39

LATIN AMERICA

COUNTRY	POPULATION (thousands)	POPULATION (1=smallest)
Antigua & Barbuda	68	8
Bahamas, The	303	23
Barbados	267	21
Belize	240	20
Dominica	73	9
Grenada	98	12
Guyana	761	35
St Kitts & Nevis	41	6
Saint Lucia	156	17
St Vincent & the Gren.	115	14
Suriname	417	26
Trinidad & Tobago	1,301	43

EAST ASIA PACIFIC

COUNTRY	POPULATION (thousands)	POPULATION (1=smallest)
Brunei	338	24
Cook Islands	20	5
Fiji	812	38
Kiribati	96	11
Marshall Islands	52	7
Micronesia, Fed. Sts.	118	15
Nauru	11	3
Niue	2	1
Palau	19	4
Samoa	170	18
Solomon Islands	447	28
Timor—Leste	800	36
Tonga	100	13
Tuvalu	11	2
Vanuatu	197	19

OTHER REGIONS

COUNTRY	POPULATION (thousands)	POPULATION (1=smallest)
Bahrain	691	33
Bhutan	805	37
Cyprus	757	34
Estonia	1,369	45
Maldives	276	22
Malta	390	25
Qatar	585	31

Source: ECCB

APPENDIX II: ECCU SELECTED DATA - 2008

REGION	POPULATION (thousands)	NOMINAL GDP (ECSM)	TOURISM RECEIPTS (ECSM)	FOREIGN DIRECT INVESTMENT (ECSM)
Anguilla	15	784.21	273.79	240.65
Antigua And Barbuda	68	3,299.81	902.42	684.08
Dominica	73	1,011.14	217.95	140.69
Grenada	98	1,831.92	283.32	435.26
Montserrat	5	135.65	19.02	5.15
St Kitts And Nevis	41	1,513.42	328.09	236.68
Saint Lucia	156	2,665.31	839.69	282.82
St Vincent and the Grenadines	115	1,571.06	243.98	326.64
ECCU	571	12,812.52	3108.26	2,351.97

Source: ECCB

The ECCU authorities have also developed an Eight Point Stabilisation and Growth Programme to address the immediate global crisis which focuses on:

- Financial Programs
- Fiscal Reform
- Debt Management
- Public Sector Investment
- Social Safety Net
- Financial Sector Safety Net
- Amalgamation of Local Banks
- Rationalisation of the Insurance Sector

The role of the international community

DISCUSSIONS ARE ONGOING with the International Monetary Fund (IMF) following Article IV consultations with individual countries, and the IMF Annual Currency Union Review to identify the types of programs that would be appropriate in the current circumstances and to work out access to Fund resources under the new arrangements following the G20 meetings. Most of the countries have already approached the Fund under the Exogenous Shock Facility (ESF).

The financial programs which each country has already formulated would be the platform on which the Fiscal Reform and Debt Management Programs will be established.

The fiscal reform program had started prior to the crisis with recommendations by a Tax Reform and Administration Commission which resulted in the implementation of value added taxes, property taxes, and adjustments to personal and business taxes. The current goal would be expenditure reform and rationalisation of government expenditures to increase the value added for critical sectors. The Caribbean Development Bank, with its Policy Based Loans and the World Bank with its Development Policy Loans are critical partners in the Fiscal Reform Program.

Debt management is being given high priority as most countries have extremely high debt to GDP ratios, which have severely limited the fiscal space to respond to the crisis. The Canadian government, the IMF, and the World Bank are supporting the ECCU member countries in taking a structured approach to effective debt management.

The boardwalk of Belize City, the nation's principal port and its financial and industrial hub.

These first three programs, vigorously executed, are the prerequisites for approaching the international community to fund and provide technical assistance for the next three.

Public sector investment programs, in the absence of domestic fiscal space, would constitute the fiscal stimulus required to generate economic activity through quickly activated and disbursing projects.

Social safety net programs through transfers and retraining are considered important to protect the vulnerable and unemployed.

Financial safety net programs require financing to restructure and recapitalize stressed institutions, and technical assistance to facilitate the development of robust regulatory and supervisory regimes.

If these three are not adequately supported by external sources then the difficulty of successfully executing the first three will increase significantly.

The amalgamation of local banks is critical to the creation of a strong banking sector that is adequately capitalized and has the capacity to survive in difficult situations. The sector is now overbanked with increased exposure of smaller and weaker banks and high overhead and unit costs.

The insurance sector is similarly overpopulated with agency arrangements that have left the sector highly fragmented and under-regulated.

These initiatives, emanating from the currency union arrangements and supported by external assistance, should help alleviate the impact of the crisis on these countries.

Conclusions

THE CONCLUSIONS that can be derived from the experience of small states in general, and those of the ECCU in particular, are as follows:

- Financial stability, given its beneficial global effects, should be considered an international public good. Efforts should be redoubled to ensure that meaningful reforms take place.
- The international community, through the IMF and the World Bank, should develop financial and social safety nets in consultation with the small states to address their particular problems.
- Small states should use the crisis to experiment with fundamental and creative fiscal and monetary policies to mitigate the impact of exogenous shocks. Given the extreme vulnerability of small states, these measures can contribute significantly to their survival and advancement in an increasingly volatile environment.

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Endnotes

1 The ECCU is comprised of the eight countries, which are members of the Eastern Caribbean Central Bank, namely, Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, Saint Lucia and St. Vincent and the Grenadines.

2 See Table 1

3 See Table 2