Small Economies in the Face of Globalisation

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at the Caribbean Development Bank

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Globalisation certainly poses new questions as to the relation between size and development. On the one hand, globalisation is making all countries smaller relative to the relevant (world) market. By reducing the transaction costs associated with distance, new technologies have reinforced this process. The relative importance of large national markets has thus declined, and even larger economies are increasingly dependent on external conditions. This is also true in terms of macroeconomic variables, as capital mobility has reduced the effective autonomy that macroeconomic authorities enjoy even in large economies.

But size has certainly not become an irrelevant factor in the current phase of globalisation. In this regard, it can be argued that small economies have both advantages and disadvantages, in particular disadvantages relating to economies of scale, less diversification and macroeconomic policy autonomy, but also –at least potential— sociological and political advantages in achieving greater social cohesion. The latter is important because these factors are generally recognised as important determinants of the investment climate and economic growth.

This lecture will explore the relevance of these factors both at a conceptual and at the empirical level, focusing on the Caribbean economies. Section I will take a look at the relationships between country size, specialisation and growth. Section II explores the effects of vulnerability to external shocks and limited macroeconomic autonomy. Section III examines implications for national, regional and global policies.

I. COUNTRY SIZE, SPECIALISATION PATTERNS AND GROWTH

In the typical post-war textbooks on economics, openness and internationalisation were supposed to be beneficial to the smaller developing economies. Their internal markets were so small that the alternative import substitution strategy pursued almost universally by their larger neighbours was not viable. Industrialisation for the larger countries, and trade diversification for the smaller ones, were once viewed as the main ingredients in the recipe for attaining high and sustainable growth in developing countries.

Development in both trade and growth theories since the 1980s has shed doubt on these conclusions, by demonstrating that, instead of facilitating convergence in productivity and income levels, trade among asymmetric countries may well lead to an increase in income gaps,

as technological advantages may be cumulative and polarisation will then be the rule rather than the exception. The essential factor in this regard is scale economies, both internal and external to firms. Thus, to the extent that small economic size implies that economies of scale and scope cannot be attained, higher production costs and an unfavourable competitive position will result. The factors underlying this result are diverse and affect both public and private sectors.

1. Indivisibility of Public Goods and Infrastructure Services

Most public goods and infrastructure services are usually characterised by their indivisibility. As a result, the cost of public services per capita is usually higher than in larger economies. Limitation of scale economies may also force states to provide –often on a subsidised basis– a wide array of goods and services that are now typically offered by private sectors in larger economies.

2. Firm Size and Production Costs

Private activities are faced with the same difficulties, because the smallness of the domestic market implies that economies of scale cannot be achieved. The new trade theory shows that trade flows in processed products –those more likely to promote industrialisation and growth– are determined by economies of scale and specialisation rather than by comparative cost advantages associated with factor endowments. Whereas economies of scale and scope may still be exploited in tradable sectors by specialising in a narrow range of products and designs –certainly at the cost of greater vulnerability to the external shocks that may affect the markets for those products—, this is not true of non-tradable sectors, for which the market is, by definition, domestic.

To the extent that non-tradable goods and services are inputs for production in tradable sectors –including such activities as domestic financing and marketing services— the absence of economies of scale in the production of the former will spill over into the competitiveness of the latter. Moreover, economies of scale or of scope in tradable sectors may be difficult to attain. This is the result of minimum efficient size requirements even in highly specialised plants and the additional costs caused by a lack of complementary tradable activities (e.g., higher costs

arising from the need to bring inputs from abroad, a lack of joint trading or advertising channels, less learning from the experience of other firms).

The role of complementary activities and firms illustrates a further point: to the extent that economies of scale are external to firms, the agglomeration of production in a few locations would tend to be the rule, generating a spatial hierarchy in which small size is certainly a disadvantage. This point has long been made by regional economics and has recently been emphasised by the literature on economic geography.

3. Market Structure, Employment and Adjustment Costs

Smallness also determines production and market structures. Being mainly composed of small firms, the domain of viable production alternatives is naturally more limited in small economies. Small firms are also financially weak and tend to be viewed by financial agents as more risky borrowers. They are thus more vulnerable to shocks than larger enterprises, including those which compete with them in international markets. On the market side, high unit costs and small market size naturally tend to create monopoly situations.

The size of labour markets matters too, and has adverse consequences for both suppliers and demanders. Because the pool of human capital is naturally limited, firms must compete for scarce labour skills and may have difficulty in finding the full range of skills they require in the labour market. On the other hand, specialised workers have very few employment alternatives. This is particularly acute when industries have to restructure. Thus, social costs associated with structural adjustment are not transitional in small economies, because alternative domestic employment is at best scarce, and at worst non-existent.

4. Advantages of Small Size

Small market size also has some microeconomic advantages, especially when it comes to diseconomies of scale associated with transaction costs. The smallness of the population involved promotes better information for economic partners (suppliers or customers) and thus reduces risks associated with information asymmetries and moral hazard. Reputation and peer pressure to behave according to established ethical standards is a partial substitute for regulation

and law enforcement. *Ceteris paribus*, smallness also favours better social cohesion and facilitates the relationship between the state and its citizens: almost by definition, public policy is decentralised in a small democratic state and there is no great distance between policy makers and policy takers. Nevertheless, these advantages materialise only when governance conditions are guaranteed.

5. Advantages and Disadvantages of Size in Practice

The observation of actual data yields a mixed confirmation of these theoretical predictions. Size matters for developing countries. Small economies worldwide tend to grow at a slower pace and have lower per capita income levels than their larger neighbours. But this relation is not linear in terms of either income level or country size. Small developed countries are not significantly different than large industrialised economies in terms of growth and income, and very small developing economies grow faster and have higher incomes than other small and medium-sized developing countries.

These trends suggest that very small developing states are able to strive and compete internationally on the basis of a narrow specialisation, based on their natural advantages. For developed countries, the size of the domestic market is no longer an obstacle for building up a modern economy and successfully competing in international trade, as the example of small European countries indicates.

On the other hand, small developing states are not small enough for their economy to rely only on exports of a few commodities or services, and their size is not large enough to reap the benefits of economies of scale or to successfully diversify into dynamic products. These small countries are therefore the most vulnerable to the challenges of globalisation and run the risk of been caught in a development trap.

These trends are also observable in Latin America and the Caribbean (LAC) over the last 20 years. Very small economies (fewer than one million inhabitants in 1990) have enjoyed a higher rate of growth in their per capita gross domestic product (GDP) than medium or larger economies (more than 10 millions habitants). Caught in between, small economies (between one and ten millions) have had the worst performance (see Table 1).

TABLE 1
LATIN AMERICA AND THE CARIBBEAN: ECONOMIC SIZE AND GROWTH TRENDS, 1981-2000
(Average annual variation of per capita GDP)

Country	1981-1990	1991-2000	1981-2000
Total [a]	-0.9	1.5	0.3
- Latin America [a]	-0.9	1.5	0.3
- Caribbean [a]	-0.9	1.0	0.0
More than 10 millions inhabitants	-0.5	1.5	0.5
1 to 10 millions inhabitants [b]	-1.2	1.1	-0.1
Fewer than 1 million inhabitants [b]	3.1	2.4	2.7

Source: Hubert Escaith, "The small economies of Latin America and the Caribbean", *CEPAL Review* No. 74, August 2001.
Notes:
a/ GDP-weighted average.
b/ Simple average.

Specialisation patterns have clearly played an important role in economic performance. One striking difference refers to the ability of several small Central American economies and the Dominican Republic to exploit the opportunities offered by the development of labour-intensive maquila manufacturing industries, facilitated by the offshore assembly provisions of the US tariff code. In contrast, in other countries, economic factors, such as higher labour costs in many CARICOM countries, and non-economic considerations (as in Haiti) have precluded a specialisation pattern of this sort. The very dynamic diversification in the exports of goods that has characterised the former has thus been absent in the latter, as Table 2 indicates.

TABLE 2
SELECTED COUNTRIES: EXPORTS BY CATEGORY OF TECHNOLOGICAL INTENSITY, 1985 AND 2000
(Percentage of exports)

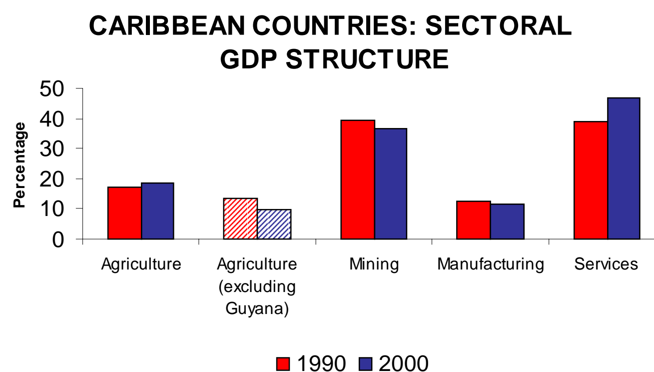
Countries/Regions	Primary products		Natural resource-based manufactures		Low-technology manufactures		Intermediate-technology manufactures		High-technology manufactures		Unclassified products	
	1985	2000	1985	2000	1985	2000	1985	2000	1985	2000	1985	2000
Latin America and the Caribbean	50,0	27,3	23,5	17,0	7,9	14,0	12,1	24,6	4,3	14,0	2,2	3,1
Central American Common Market	71,6	27,7	10,9	9,2	8,5	39,7	4,4	6,6	3,7	14,5	0,9	2,2
CARICOM	41,7	37,4	39,3	34,9	5,4	10,2	5,7	11,6	6,0	1,4	1,9	4,6
Haiti	18,4	8,9	4,5	2,9	52,8	85,2	14,3	1,0	7,5	0,3	2,5	1,6
Dominican Republic	23,7	4,9	24,3	8,6	28,2	62,7	9,9	17,5	1,1	3,5	12,8	2,9

Source: ECLAC, on the basis of information obtained from the CAN (Competitive Analysis of Nations) computer software (2002 version).

This is also reflected in the relative dynamism of manufacturing in several Central American countries vs. the decline experienced by manufacturing in the CARICOM countries from what were already low levels (Figure 1). In some of the larger countries (Barbados, Jamaica

and Trinidad and Tobago), the manufacturing sector has also experienced the effects of import competition, as these industries were developed on the basis of import-substituting industrialisation.

FIGURE 1



Source: ECLAC.

Agriculture has, in turn, suffered in the CARICOM countries as a result of their limited competitiveness and the erosion of preferences granted to them by European countries in the context of the Lomé Convention and its successor, the Cotonou Convention, some of which were successfully challenged in the WTO (those associated with bananas). Agriculture (excluding Guyana) and mining experienced a net relative contraction in the 1990s (Figure 1). Thus, in the CARICOM countries growth has depended on services, which have increased their share in GDP from 39% in 1990 to 47% in 2000. There are, of course, some exceptions to this rule, including Guyana (a dynamic sugar industry) and Trinidad and Tobago (growing gas production).

The development of services has reinforced a dual specialisation pattern in the Caribbean, which consists of both goods-producing and service-based economies. The two types of economies have reacted differently to globalisation. Generally, the service-based economies (including Antigua and Barbuda, the Bahamas, Barbados, British Virgin Islands, Cayman Islands, St. Lucia and St. Kitts and Nevis) have shown a more robust response to globalisation. This is reflected in the fact that, on average, their trade and growth performances have surpassed those of the goods-producing economies, with the exception of Trinidad and Tobago. [1]

[1] Sir Alister McIntyre, "Changing Perceptions of Development: Their Implication for the Caribbean", *Inaugural William G. Demas Memorial Lecture*, Caribbean Development Bank, October 2000; ECLAC, *Globalization and Development*, Santiago, 2002, ch. 11.

This difference in performance is related to the international product cycle and, particularly, the elastic demand for tourism, the major service sector in the sub-region. External competition has, nonetheless, eroded the comparative advantage of some of the tourism-based economies, particularly in the smaller countries. The development of industries associated with information and communications technologies (ICT) has also offered opportunities to some countries, particularly Barbados and Jamaica. The fact that English is a native language has represented an advantage in this case, whereas the recent crisis of the ICT sector and the monopolistic provision of telecommunications services (only recently being eroded) have represented disadvantages. Offshore banking services have run into difficulties in recent years owing to weak regulation and supervision and other problems that have come under close international scrutiny, particularly by the OECD Financial Action Task Force.

Interestingly, proximity to the United States has facilitated emigration in most small LAC states. Worker remittances sent from abroad have thus become another important source of income in many Caribbean and Central American countries. By the end of the 1990s, such flows represented 17% of Haiti's GDP, and over 10% of GDP in El Salvador, Jamaica and Dominican Republic. Remittances have also been significant in Grenada and St. Kitts/Nevis. The economic and social role of migration and remittances in a context of globalisation is a key point that will be developed later in this lecture.

II. STRUCTURAL VULNERABILITY

Transcending development levels, smaller countries are consistently more vulnerable to external shocks than larger ones. Thus, vulnerability is the other relevant facet –besides growth and income– for analysing the relationship between country size and economic welfare in the context of open, globalised economies. Vulnerability is attributable to interrelated geographic (country size and location), demographic and economic factors.

1. Geographic and Demographic Factors

The conjunction of geographic and demographic factors leads to higher population density and increases the pressure on already limited domestic resources, in particular water and arable land, and threatens fragile ecosystems. Location in tropical areas prone to natural disasters (hurricanes, earthquakes or volcanic activities) compounds the problem. In many of the region's small states, natural disasters are recurrent and affect a large proportion of the national population and economy. In some cases, particularly in small island developing states, the economic damages have exceeded the economies' annual GDP. In the face of such catastrophes, the capacity of national authorities to cope domestically with the costs of reconstruction is limited.

2. Trade and Capital Account Shocks

Economic characteristics of smaller economies are another source of risk. In particular, their level of openness may entail a high degree of vulnerability to external shocks. Small Latin American and Caribbean countries are much more open than the larger ones: in the 1990s, imports plus exports of goods and services as a percentage of GDP averaged about 85% for the former and only 30% for the latter. Moreover, exports from the small countries tend to be highly concentrated in a narrow range of products and markets. Thus, they are very exposed to external shocks in prices and quantities and tend to suffer from higher terms-of-trade volatility than larger states.

Dependence on trade preferences has been a further source of vulnerability over the past decade. Erosion of preferences, as in the case of bananas, has been a major problem, as already pointed out. Also, improved preferences granted to competitors has become a major problem in other cases. According to the Caribbean Textile and Apparel Institute, approximately 150 companies have closed their operations and relocated to Mexico since NAFTA came into force. This problem was finally addressed by granting Caribbean Basin countries a closer NAFTA parity under the Caribbean Basin Economic Recovery Act.

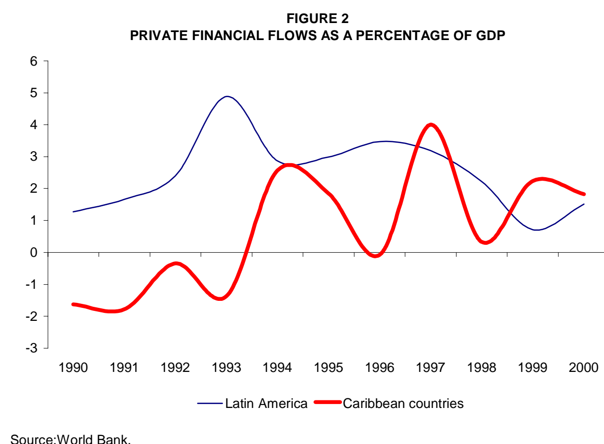
Additionally, some export activities –primarily apparel and assembly plants in export processing zones, but also investment in tourism– benefit from fiscal subsidies granted by small

economies, further eroding the tax base of public finances and increasing economic vulnerability. [2] I will return to this issue below.

It is usually argued that this trade-related external vulnerability is compensated for by a relative immunity to financial shocks, which was the major cause of crises during the last decade. According to this view, since most small states do not have a significant financial market that could attract large flows of speculative short-term capital, the volatility that characterises this type of flow does not have the domestic systemic effects that it has in large Latin American countries.

Actually, however, this argument is not entirely consistent with the evidence. Figure 2, which compares private financial flows (i.e., excluding foreign direct investment) to Latin American and Caribbean countries over the 1990-2000 period, indicates that the latter have actually been more volatile than the former. Thus, the small Caribbean countries have not been spared from the boom and bust cycle linked to the pro-cyclical behaviour of private capital flows. Moreover, as we will see below, this factor has been compounded by the volatility of official flows.

Nor were small economies in the region immune to the problems posed by financial liberalisation and deregulation in the presence of weak financial regulation and supervision. In the Caribbean region, Jamaica's financial crisis during the second half of the 1990s illustrates this danger.



[2] Escaith, Hubert and Keiji Inoue, "Small Economies´Tariff and Subsidy Policies in the Face of Trade Liberalisation in the Americas" *Integration and Trade* 5: 14, May-August 2001, Buenos Aires: IDB-INTAL.

3. Macroeconomic Policies

The shallowness of domestic financial sectors, low domestic savings rates, and reduced margins for changes in relative prices due to strong links between domestic and international prices exacerbate the traditional macroeconomic constraints faced by open developing economies. Under these conditions, it is more difficult to cushion shocks by resorting to internal financing or devaluing the currency. More than anywhere else, macroeconomic policy has been geared towards controlling inflation and preserving nominal exchange rate parity, two closely interwoven targets in small open economies.

Most small countries in the LAC region kept a fixed exchange rate regime for a long time after the 1971 collapse of the Bretton Woods arrangements. Some countries eventually devalued their currencies, starting with Costa Rica in December 1980. In the Caribbean, several countries (Guyana, Jamaica, Trinidad & Tobago) defended the parity during many years at the cost of overvaluation in the face of serious fiscal and balance-of-payments deficits, only to give way to devaluation and adjustment programmes later on. Those countries that abandoned a fixed exchange rate have been unwilling to give up the advantages of a more flexible exchange rate. Only the smaller Eastern Caribbean countries have been able to maintain a fixed exchange rate with the US dollar, thanks to a currency board arrangement and a strong fiscal discipline.

The commitment to fixed exchange rates has reinforced price stability. However, it has also placed the burden of adjustment to external shocks on income effects, thus reinforcing the risk that large shocks and misalignments may translate into recession and unemployment. Furthermore, when this kind of exchange rate policy has resulted in overvaluation, persistent pressures on the balance of payments has adversely affected growth and increased the dependence on external financing.

4. Fiscal Vulnerability

In a framework where monetary policy is determined by the exchange rate regime and the domestic financial sector has little depth, the scope for autonomous fiscal policy is naturally reduced. Additionally, in many small countries current government income is quite dependant on trade tax revenues, and public investment depends largely on official assistance.

Obviously, the situation is potentially worse for those countries which are both dependent on trade taxes and face a relatively large fiscal deficit. As shown in Table 3, a group of ten LAC countries is in this most vulnerable situation, despite having, in several cases, relatively high levels of government revenues. With the exception of Colombia, all of them are fairly small. A second group of vulnerable economies are characterised by either large deficits and a moderate dependency on trade revenues, or by moderate deficits and a high dependency on such revenues. Except for Ecuador and Venezuela, this group also mostly includes Caribbean economies. At the other extreme there is Trinidad and Tobago, which has high trade exposure but managed to have a diversified tax structure with increasing revenues and stable expenditures throughout the 1990s.

Table 3
Latin America and the Caribbean: Fiscal balance and dependency on trade taxes
(1995-1999 averages)

DEPENDENCY ON TRADE REVENUES	SURPLUS OR SMALL DEFICIT	MODERATE DEFICIT	LARGE DEFICIT
LOW	Trinidad & Tobago	El Salvador Mexico	Bolivia Brazil Costa Rica Uruguay
MODERATE	Chile	Argentina Barbados Guatemala Panama Paraguay Peru	Ecuador Guyana
HIGH	Dominican Republic	Netherlands Antilles St. Kitts & Nevis St. Lucia St. Vincent & the Grenadines Venezuela	Antigua & Barbuda Bahamas Belize Colombia Dominica Grenada Haiti Honduras Nicaragua Jamaica

Source: Hubert Escaith and Keiji Inoue (2001), "Small Economies' Tariff and Subsidy Policies in the Face of Trade Liberalisation in the Americas", *Integration and Trade*, Vol. 15, No. 14, May-August.

Note: Deficit levels are strictly for comparison purposes and do not necessarily imply fiscal fragility. These levels are the average deficits in 1995-1999. Countries at the upper end of the sample had average deficits of over 2% of GDP (and/or had volatile changes in their deficits); a middle group had deficits between 1% and 2% of GDP, and another group had surpluses or deficits of less than 1%. Dependency on trade revenue was approximated by looking at four indicators (two on trade revenues, two on average tariffs). For each indicator, three categories were defined according to the distribution of the data in the sample of countries.

Greater consensus on what constitutes good fiscal policy has facilitated fiscal reform in the Caribbean, focusing on prudent and efficient expenditure management and strengthened

revenue collection. Progressive import liberalisation has reduced revenues from international trade taxes, especially for countries that are heavily dependent on such taxes. The VAT in countries such as Jamaica and Trinidad and Tobago has compensated for the loss of revenue from international trade taxes.

The implications of import liberalisation for the smaller of these countries (e.g., the OECS countries) are greater. International trade taxes account for up to 60% of government revenue in some countries. Tax reform would pose a major challenge in countries such as Antigua and Barbuda and St. Kitts and Nevis, where personal income tax has been abolished for a number of years. In Antigua and Barbuda, recent attempts to introduce relatively low sales and income taxes met with major public opposition.

In any case, countries that are the most heavily dependent on trade taxes will have to adopt alternative measures in the medium term at least. A VAT or some combination of alternative taxes would have to be considered, although they may be politically difficult to implement.

5. Asymmetric Access to Investment Finance

A major source of vulnerability in public finances in small economies, particularly in the Caribbean, is their dependence on official capital flows and development assistance (ODA). As Figure 3 indicates, these flows diminished considerably and underwent large fluctuations during the 1990s (Table 4). A number of factors contributed to the decline in ODA, in particular "aid fatigue" in the industrial countries and the change of focus towards the poorest countries and other geo-political areas (such as Central and Eastern Europe).

FIGURE 3
OFFICIAL FLOWS TO CARIBBEAN COUNTRIES

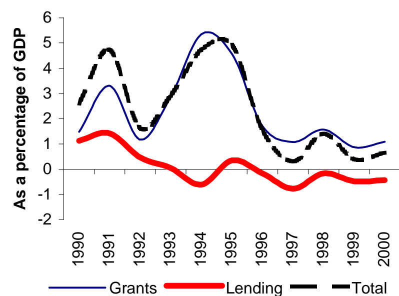
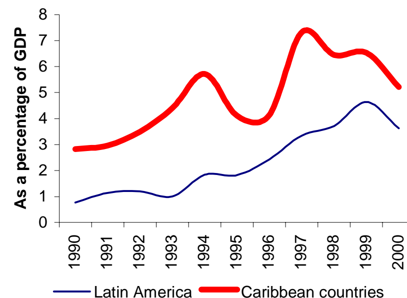


FIGURE 4
FOREIGN DIRECT INVESTMENT



Source: Estimated on the basis of World Bank data.

TABLE 4
RESOURCE FLOWS AND GRANTS
TO LATIN AMERICA AND THE CARIBBEAN
(Percentages of GNP, 1990-2000)

	Latin America		Caribbean countries	
	Average	ST Dev	Average	ST Dev
Private capital flows				
Long term	4.3	1.8	4.7	2.4
Foreign Direct Investment	2.3	1.3	4.8	1.5
Other	2.0	1.0	-0.2	1.1
Short term	0.5	0.7	0.8	1.6
Official capital flows	0.3	0.4	2.3	1.8
Lending	0.1	0.3	0.1	0.7
Grants	0.2	0.1	2.3	1.5

Source: Estimated on the basis of World Bank data.

As a consequence, there has been a greater reliance on private capital flows, particularly of FDI, to finance development projects in the Caribbean. Indeed, long-term capital flows towards the Caribbean have been, on average, small and volatile, whereas FDI in relation to GDP has exceeded the also rising levels reached in Latin America (Figure 4). Nonetheless, this trend has tended to exacerbate income differences and widen the gap between winners and losers in the globalisation process. In Central America, the most advanced economy (Costa Rica) was able to attract a high level of investment in new technologies and to shift towards higher value added ICT manufacturing. In the Caribbean, the relatively underdeveloped countries such as Haiti and Suriname and some smaller OECS countries, most notably Antigua and Barbuda and Dominica, have been unable to attract significant private flows, whereas Trinidad and Tobago has attracted large flows.

The combination of declining official flows and uneven access to private international financial markets has thus affected the ability of some Caribbean islands to finance viable development projects.

III. FACING THE CHALLENGES AND SEIZING THE OPPORTUNITIES

Like other LAC economies, the Central American and Caribbean countries embarked on a series of reforms in the 1990s involving market liberalisation combined with monetary and fiscal discipline. The new trade regime moved away from inward-looking strategies and towards

open regionalism. As such, it combined deeper regional integration with a stronger orientation towards extrarregional markets. Yet structural conditions in smaller economies impose particular constraints, calling for specific measures by national governments and multilateral (regional or international) bodies to create greater margins of flexibility for national and regional development strategies aimed at overcoming these constraints.

1. The Role of National Economic Policies

a) Macroeconomic policies

The size of smaller economies and their traditional openness determine, to a great extent, their style of macroeconomic policy and their manoeuvring room. In particular, incomplete domestic markets and shallow financial sectors amplify shocks and tend to reduce the scope for autonomous monetary policies. This is especially true when both trade and capital accounts are very open. Nevertheless, even in this context, there are still options available which small economies have generally failed to explore. In particular, with notable exceptions, very open smaller economies have been reluctant to manage the exchange rate as a macroeconomic policy variable and have thus been more prone to stick to rules-based and nominally anchored macroeconomic policies, which tend to shift all the burden of adjustment to domestic income.

Macroeconomic policy in a globalised world should not be tied solely to the reduction of inflation, especially when it is accompanied by an increase in the volatility of growth, as it has been in the LAC region over the 1990s. Macroeconomic stability should be pursued with a broad view of stability in mind, which includes not only price but also real economic stability and sustainable balance of payments accounts. This means, first of all, loosening the tight link between balance-of-payments performance and the monetary policy stance. This could be accomplished by providing greater exchange-rate flexibility in order to mitigate external disequilibria.

Given the restrictions associated with thin financial and currency markets, and the closer connections between domestic prices and nominal exchange rates characteristic of small economies, the options for flexibility are limited to fixed but adjustable pegs, crawling pegs or floats with strong central bank intervention. The successful history of monetary arrangements in the Eastern Caribbean shows that monetary union continues to be the best alternative for that

group of countries. However, a broader monetary union does not seem to be a viable alternative, as the CARICOM region is not an optimum currency area. [3] There are several arrangements for macroeconomic and financial co-ordination that are, nonetheless, attractive, including: macroeconomic surveillance based on agreed common macroeconomic targets (reserve to imports cover, external debt service levels, ratios of budget deficit and public sector debt to GDP, and a degree of exchange rate stability under "normal" circumstances), a reserve fund or central bank swap arrangements to support CARICOM members facing balance-of-payments crises, common standards for prudential regulation and supervision, and a programme to create a regional capital market. Under any exchange rate arrangement, countries should not rule out the use of capital account regulations for macroeconomic purposes.

Macroeconomic stability, in the broad sense in which we use this term, and long-term economic growth not only hinge up on competitive exchange rates and moderate real interest rates, as a result of more flexible policies, but also depend on sound fiscal systems that provide the necessary resources for the public sector to do its job and on deep financial markets.

A corollary of this policy package is the need to adopt medium-term fiscal frameworks that allow for the use of suitable instruments, particularly broad tax stabilisation funds that will facilitate counter-cyclical fiscal management. It is also necessary to strengthen the fiscal balance through more efficient administration together with a reduction in reliance on trade taxes and a shift in the burden of taxation to internal sources.

Fiscal policy can be used to obtain resources from those activities that benefit from the process of globalisation, first of all by limiting –through a regional code on fair competition– the extension of tax holidays to attract FDI. Improvements in a country's fiscal stance should also strengthen national saving, a move that favours the deepening of domestic financial markets and reduced dependence on external flows.

The key objective of financial deepening is to provide suitably priced investment finance with sufficiently long maturities to domestic investors. In the absence of a well developed financial market, many investors (particularly the larger ones) turn to international lenders, thereby substituting exchange risk for maturity risk. Furthermore, use of international financing

[3] The Committee of Central Bank Governors, *Report on the Reconsideration of Caribbean Monetary Union (CMU)*, June 2001.

is well beyond the reach of the smaller firms that form the bulk of the industrial base in small developing economies. Multilateral financial institutions should play a greater role in fostering domestic and in creating regional capital markets, as we shall see below.

b) Structural strategies

Trade specialisation in the Caribbean has witnessed the creation of a duality in the pattern of trade specialisation between commodities-producing economies and services-based economies. The latter type of economy has been able to withstand the impact of globalisation more successfully than the former. The coexistence of stagnant and dynamic sectors and economies with little connection between them has forced a restructuring of the lagging sectors that has entailed major costs in terms of output and employment.

In small economies, a competitive group of small firms cannot be expected to emerge spontaneously because of the lack of adequate externalities and the inherent learning processes involved. Moreover, in more general terms, the experience of the LAC region over the 1990s indicates that a dynamic structural transformation is not an automatic outcome of macroeconomic stability plus open trade and investment rules. Policy intervention is required to stimulate strategic change and promote alliances between existing firms that will lead to the formation of dynamic and competitive productive and technological linkages.

This policy should be based on investment (productive development) strategies adopted by countries or, preferably, groups of countries within the context of CARICOM. The smoother flow of information in smaller economies, together with the possibility of closer interaction between the public and private sectors, facilitate the design of policies aimed at building dynamic production clusters.

Clusters associated with the development of services –particularly tourism, but also modern services in informatics, electronic commerce and finance– are particularly attractive for the region. Electronic commerce offers, indeed, new prospects for small, geographically isolated economies that are enhanced by certain cultural specifics (native English-speaking communities). This is also true of other niche markets in services, especially information-based activities (from simple data processing to development of software) and some financial services. Moving the maquila activities up the value-added ladder, as has been done in Costa Rica, is

another option that should be explored. In those countries where agriculture and mining are competitive, clusters associated with their key primary sectors are also an interesting option.

Strong investment in human capital is a key ingredient of a strategy aimed at high-value-added service sectors. Indeed, more broadly speaking, high levels of human capital may be crucial to compensate for other disadvantages, including those associated with size or limited endowments of natural resources, and have been key to the success of the smaller developed economies in Europe. Fiscal considerations have certainly not stopped small economies, especially countries in the Caribbean (e.g., Barbados, among others) and some small Latin American countries (Costa Rica and Uruguay), from developing a very active public policy of investment in human capital. In fact, as indicated above, small size promotes a closer association between the State and its citizens and should favour less bureaucratic forms of allocating public funds.

The mix of an investment strategy, strong human capital accumulation and a broad macroeconomic framework could help to improve the competitiveness of exports by diversifying their base, which is one the greatest challenges for smaller Caribbean economies. Progress on these fronts will require major institutional and organisational efforts to formulate and implement active investment strategies. Not only were the pre-existing systems of government intervention in productive development dismantled or severely curtailed in most of the countries during the economic liberalisation phase, but such systems would, in any case, be ill-suited to the new environment. In this area, as in others, it is necessary to "invent" new institutions, whose management will no doubt require an intensive learning process. These institutions should comprise various combinations of horizontal and selective instruments, depending on each country's context, to be chosen on the basis of strategic visions shared by both public and private sectors. In ECLAC's view, this is less an exercise in "picking winners", as it has often been disparagingly referred to, than an effort to identify opportunities, based on national strengths and international trends, and to direct the national and regional actions needed to ensure that some of them bear fruit.

2. Open Regionalism and International Mechanisms to Support the Development of Small Economies

a) Strengthening the regional agenda

Latin America, and especially the Caribbean, have progressed further in terms of regional integration than any other region in the developing world. The evidence indicates that integration tends to create rather than divert trade flows. Moreover, the trade flows it generates tend to be of a high quality. This is borne out by the tendency of regional flows to have greater technological content and to create more production linkages.

One of the main advantages of these processes is that countries with similar levels of development can take advantage of specialisation economies that generate intra-industry trade. Another advantage is that lower transaction costs allow smaller firms to participate in intrarregional trade. This helps to counter the effect of production asymmetries and the tendency for external trade operations to be in the hands of larger firms.

If regional integration processes are to remain relevant under current global trends, they will need to be deepened in the future. As indicated above, macroeconomic co-ordination provides an appropriate framework for the design of broad-based frameworks that can help to smooth out the effects of external shocks, and it plays a crucial role in the consolidation of trade integration processes. The prudential regulation and supervision of national financial systems also stands to benefit from progress in the exchange of information, peer reviews and the development of common standards and, eventually, common supervision. Avoiding tax competition is also an essential objective that could, preferably, be achieved by means of common tax provisions.

In tandem with these efforts, ECLAC has argued that steps must be taken to develop regional and subregional financial institutions. Latin America and the Caribbean already have major assets of this type, including the Caribbean Development Bank. Support by this institution, as well as by the Inter-American Development Bank and the World Bank, for the generation of greater degrees of freedom for the adoption of counter-cyclical macroeconomic policies is particularly important. This can be achieved by making specific instruments available in this area, such as long-term credit lines with a clear counter-cyclical disbursement component, tied to the adoption of fiscal stabilisation funds in the countries that receive such financing. Multilateral

credit institutions should also play a central role in developing deeper domestic and creating regional capital markets, in supporting smaller countries in their initial issues on private capital markets, and in designing instruments to cover the special risks of smaller economies (e.g., natural hazards and critical conditions faced by export sectors).

As has also been pointed out, active investment strategies aimed at better integration into the world economy should preferably be pursued as sub-regional strategies, and should also be supported by multilateral financial institutions. They could provide for joint marketing strategies and common financial services, including integrated capital markets and common credit guarantee funds for small enterprises. In areas which are crucial for systemic competitiveness, such as transportation and communications, common strategies may be essential to deal with large multinational firms that adopt monopolistic practices vis-à-vis small economies. Common institutions may thus be optimal in relation to competition policies and utilities regulation.

Since asymmetries that characterised the globalisation process are closely linked to differences in access to technology (including the "digital divide"), an essential ingredient of investment strategies is the generation of regional and subregional innovation systems. This should include the development of broader schemes for co-operation in education, research and technical development. They could also provide a suitable framework for strategic alliances in the areas of research and development or for the formation of new production clusters made up either of domestic firms in countries that are members of a regional or subregional agreement or of these firms and transnational corporations.

CARICOM's strategies for building a single market and economy certainly provide an adequate framework for deepening integration along these lines. The creation, in 1994, of the Association of Caribbean States to promote greater co-operation in the Caribbean basin, within the areas of competence of the Association, is another example.

b) International support for small economies

The forces of divergence in development levels associated with scale economies, and the vulnerabilities that are specific to small economies, provide a strong argument for special and differential treatment for these economies. In multilateral trade agreements, this would include longer transition periods to meet new policy demands, more flexibility in setting thresholds (e.g.,

in rules of origin) or defining legal and institutional obligations, more manoeuvring room for active investment strategies, broader safeguards and the provision of technical assistance. Some of these special provisions can be temporary but most should be permanent. Such provisions should also be incorporated into agreements on trade in services as well as trade-related investment measures. The principle of differential treatment for small economies has not been fully incorporated into international trade practices, though it has been accepted as a criteria in ongoing FTAA negotiations.

Free trade, even with special provisions, may be inadequate, however, to ensure convergence among economies of different sizes and levels of development. Structural funds aimed at guaranteeing convergence by strengthening the physical, educational and institutional infrastructure of small and poor economies are an essential complement. In the European Union, structural funds aimed at bridging structural gaps were one of the key ingredients of the high growth rates observed in previously laggard countries, such as Ireland or Portugal. By speeding up the catching-up process, structural transfers from rich countries to poorer ones have multiplied the growth potential of free trade and contributed to the success of European integration. Capitalising on the commitment made by industrialised countries during the recent International Conference on Financing for Development in Monterrey, this should be reflected in a turnaround of the trend in official development assistance. According to the arguments provided in this lecture, size should be, along with income levels, a criterion for targeting international assistance.

Finally, the combination of high vulnerability and limited flexibility characteristic of small economies indicates that special financial arrangements should be made available to them to manage external shocks. [4] Such mechanism could be provided by a small-country liquidity fund in the International Monetary Fund or a fast-disbursing fund administered by multilateral development banks. According to the principle of subsidiarity, decentralization in the management of these funds would be highly desirable. They should thus provide rediscount windows to which regional reserve funds or banks (such as the Caribbean Development Bank) can have automatic access.

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[4] Gerry Helleiner, "Poverty Reduction in Small Countries: What is to be Done?", *Second Annual William G. Demas* Lecture, May 2001.

c) International labour mobility and links between migration and development

Smaller economies are especially vulnerable to structural shocks, and adjustments have a particularly strong impact on domestic labour markets. The social costs associated with globalisation are particularly difficult to absorb on a purely national basis. Promoting greater international labour mobility is thus a clear priority for smaller economies. On the other hand, the diseconomies of scale characteristic of labour markets in small economies indicate that firms must look at regional or even international markets to find the required labour skills. This represents an additional argument for greater international labour mobility.

Labour migration not only smoothes out the social costs of adjustment and guarantees access to the required pool of skilled workers: it provides much-needed external resources to cash-constrained economies. Remittances have become a key factor of development in small economies in the LAC region. The benefits of return migration are equally evident. Professionals who studied abroad and joined the labour force in their host countries, or nationals who have completed their working life abroad, are returning to their countries to set up business or retire in the region.

One of the priority items on the international agenda should therefore be to forge agreements that will increase labour mobility and strengthen the governance of international migration. The main objective here should be the conclusion of a global agreement on migration policy. A first step in this direction is the ratification of the International Convention on the Protection of the Rights of All Migrant Workers and Members of their Families, approved by the United Nations General Assembly in 1990.

Broadening the commitments made in regard to temporary mobility of workers within the framework of the WTO General Agreement on Trade in Services is another important objective. One of the priorities in this area is to secure greater commitments on the part of industrialised countries with respect to services that are intensive in low-skilled labour, in which developing countries may have comparative advantages.

Migration issues should also be included on the hemispheric agenda, in multilateral negotiations between the LAC region and the European Union, and in regional integration processes. Access to a regional pool of skilled labour, as well as to a regional capital market, is

particularly important in small economies, as Sir Alister McIntyre has emphasised. [5] There is also a wide range of bilateral conventions and negotiations that can help to provide greater opportunities for international migration. All of these agreement should seek to increase temporary and permanent labour mobility and to move forward on the issues closely related to migration, such as social security and the recognition of individuals' academic and vocational qualifications.

Home countries of migrants can also seek to benefit from this process in various ways. One way is to improve the flow of remittances and to provide for their use for development purposes (e.g., through special provisions for saving by migrants in their home countries and solidarity funds through which migrants can contribute to their community of origin). Another is the use of links with emigrants to give their home countries the benefit of their scientific, professional and entrepreneurial skills. Promoting return migration with a view to the establishment of firms based on the experience of migrants abroad is also an interesting alternative.

[5] "The quality of regional arrangements regarding factor markets, particularly for labour services, will be a more important determinant of investment and export expansion than national economic policy regimes, even although these are important in themselves. Entrepreneurs will be looking for regional pools of capital and skilled labour, particularly in the professional and semi-professional categories. This would be an essential ingredient in absorbing the technology underpinning the New Economy.", McIntyre, op.cit., p. 16.