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The Economic Consequences of Smallness

4.1 Small economic size is widely believed to impose certain obstacles to economic development. While these were briefly surveyed in the *Vulnerability* report we amplify them here given the greater importance of the economic dimension for the future security and development of small states. The first section surveys some economic propositions relating to small states followed by a review of the latest evidence on the economic performance of small states.

Economic Consequences of Small Economic Size

4.2 There are considerable differences in average per capita incomes among small states and in their economic structure. These are given in Table 4.1 which contains data on the percentage distribution of GDP between three main economic sectors – agriculture (including fishing and forestry), industry (including manufacturing, mining, construction and utilities) and services for most countries earlier identified as small states. It shows that in the poorest states (Guyana and Lesotho excepted) agriculture is responsible for generating a large percentage of GDP and that most are comparatively unindustrialised. As per capita income rises, agriculture tends to diminish relatively as a source of income and industry accounts for a growing share of GDP. In some countries significant degrees of industrialisation have been achieved based on successful exploitation of mineral and fuel wealth and to a lesser extent on manufacturing. At the highest levels of income, services tend to be the most important sector with tourism and the provision of offshore financial services being particularly important. There are also some important regional differences. In the South Pacific the main sources of income are agriculture and services and the industrial sector is generally underdeveloped. In the Caribbean agriculture has declined and while industry remains significant in the economy, the service sector is growing rapidly. In several African small states industry (including manufacturing) has grown significantly in recent years.

4.3 Whatever their level of income or economic structure, all of them face obstacles to development on account of their small size. Two structural differences between small and large economies stand out. First, economic activities tend to be less diversified and more specialised than in large economies due to their narrower human and non-human

resource base and limited domestic market. While this constraint is observable in a range of activities it is most acutely felt in the inability of small states to sustain what may be termed 'advanced' branches of manufacturing industry, such as capital goods, metal-working and intermediate manufacturing sectors. These activities are characterised by economies of scale in production, product development and R&D and typically require a domestic market of a certain minimum size in order to become established. In their absence small states are typically more dependent on non-manufacturing (in the primary and tertiary sectors of the economy) as a source of output, employment and foreign exchange receipts or remain limited in their manufacturing capacity to basic 'low technology' manufacturing activities which are not affected by domestic market size.

4.4 Small states also suffer from diseconomies of scale in investment, transportation and the provision of government services. Generally, small countries suffer, to varying degrees, from higher unit costs of investment in the industrial sector, particularly in new technology and in capital intensive manufacturing, a disadvantage trade can only partly overcome. They also have higher per capita costs in establishing basic infrastructure because of higher unit costs. They also need more infrastructure per capita because of indivisibilities i.e. the provision of facilities that may not be fully used such as roads, airports, harbours and communication facilities. High per capita costs also arise in public administration where a minimum structure of government and level of services is necessary irrespective of size. At the same time, it follows that the smaller the country the more acute such diseconomies of scale are likely to be, with corresponding severe effects.

4.5 Second, small economies exhibit an exceptionally high degree of openness to external economic developments, in respect of trade, capital flows and technology. There are high levels of commodity export concentration which limit possibilities for internal diversification. This makes for a high degree of sensitivity to, and dependence on, the international economic environment combined with a limited capacity to stabilise the domestic economy in the face of external shocks. In short, small states suffer a greatly reduced degree of national economic sovereignty and limited capacity to control domestic economic variables so as to affect their own economic destiny.

4.6 In practice, it is this second structural characteristic of openness which has come to dominate the discussion on small state economic disadvantage. It emphasises the vulnerability of small states and therefore requires further consideration. At the same time, openness can provide opportunities and benefits for small states. This is noted on page 27 as well as in the discussion on globalisation.

Table 4.1 Small States*: Per Capita GNP and Distribution of GDP, 1995

(countries ranked by per capita GNP)

	Per Capita GNP US$	Sectoral Distribution of GDP (%)		
		Agriculture	Industry	Services
Guinea-Bissau	250	47	18	35
The Gambia	320	28	15	58
Sao Tome e Principe	350	21	26	53
Equatorial Guinea	380	50	33	17
Comoros	470	39	13	48
Guyana	590	39	23	38
Lesotho	770	10	56	34
Djibouti	780 (93)	3	21	76
Suriname	880	26	26	48
Solomon Islands	910	44	3	53
Kiribati	920	24	9	67
Cape Verde	960	7	14	79
Maldives	990	22	17	61
Tuvalu	1,050 (94)	n/a	n/a	n/a
Samoa	1,120	40	20	40
Papua New Guinea	1,160	26	42	32
Swaziland	1,170	12	39	50
Vanuatu	1,200	20	14	66
Jamaica	1,510	8	41	51
Tonga	1,630	38	19	43
Namibia	2,000	11	26	63
St Vincent and the Grenadines	2,280	10	19	71
Fiji	2,440	21	18	61
Belize	2,630	20	27	53
Grenada	2,980	11	19	70
Dominica	2,990	21	22	57
Botswana	3,020	6	47	47
St Lucia	3,370	11	14	75
Mauritius	3,380	9	32	59
Trinidad and Tobago	3,770	2	43	55
Gabon	3,980	8	53	39
St Kitts and Nevis	5,170	6	25	69
Barbados	6,560	5	16	79
Seychelles	6,620	4	15	81
Antigua and Barbuda	7,330	4	19	77
Bahrain	7,840	1	42	57
Malta	7,970 (93)	3	35	62
Nauru	8,070 (93)	n/a	n/a	n/a
Cyprus	10,380	6	25	69
The Bahamas	11,940	2	14	83
Brunei Darussalam	14,240 (94)	3	52	45

*Reliable data for Micronesia, Marshall Islands and Palau listed in table 2.1 are not available; Commonwealth countries are shown in **bold**.

Source: World Bank data base and Commonwealth Secretariat, *Small States: Economic Review and Basic Statistics*, 1997.

Trade openness

4.7 Trade openness is seen in an economy in which many of the goods produced are exported, many of the goods sold imported, and in which services, some of which such as tourism and offshore banking are primarily directed at foreigners, are very important. High trade openness increases a country's vulnerability to external shocks. Such shocks on the export side, whether of demand and/or supply, can affect both the price and/or quantity of exports and cause considerable short-term instability in export earnings. This, in turn, can transmit into instability in final demand – in the absence of adequate stabilising measures – an effect which will be greater the more open the economy. Instability in domestic demand may have adverse consequences, due to enhanced uncertainty, on the level of investment and, hence, on the long-term growth rate of the economy. Meanwhile, prolonged depression in relative primary product prices, such as occurred during the 1980s can, through the loss of dynamism imparted to the growth of final demand and the imposition of constraints on the real capacity to import, impart strong stagnationist tendencies to the medium-term growth rate.

4.8 On the import side, external shocks consist principally of price changes which in a very open economy have the capacity to impart strong inflationary or deflationary impulses to the domestic price level. Not all small states are highly 'open' on the export side. Some, especially a number of small South Pacific island economies, have such a weak resource base and a consequent dearth of international competitive exports that their export: GDP ratios are quite low. High trade openness for them expresses itself in a high ratio of imports: GDP – and, given the weaknesses on the export side, the resulting substantial external trade imbalance can only be sustained by resort to transfers from abroad (including intergovernmental transfers and workers' remittances).

4.9 At the same time it is important to recognise that trade openness can be a source of strength as well as weakness: a source of vitality as well as vulnerability. A country which derives a large proportion of final demand from exports has potential international dynamism so long as the country's exports are located in dynamic, rapidly-expanding branches of world trade. Rapid growth of export earnings can result in rapid increases in efficiency and product quality and rapid increases in the capacity to import, thereby releasing the restriction posed by the foreign exchange constraint on growth.

Commodity export concentration

4.10 In Commonwealth small states exports account for well over 50% of GDP in the majority of countries. A feature of export patterns

is a high degree of specialisation in a narrow range of products in order to secure economies of scale in production, marketing, transportation and distribution. Such specialisation increases a country's exposure to export price and quantity risk in the short-term, giving rise to earnings instability. Also in the medium and long-term, a country may find its resources excessively committed to slowly growing segments of world trade. Where a high degree of commodity concentration is linked to a dominant (i.e. price-setting) position in world trade, price and quantity movements may be off-set. However, most small states, even where their commodity exports are highly concentrated, are unlikely to be price-setters.

4.11 Export diversification generally serves to reduce the price and quantity risks due to concentration. In practice, many small states have experienced quite considerable diversification of their export earnings in recent years. Their commodity exports have been diversified via the growth of manufactured exports as well as non-traditional primary products. Furthermore, in many small states, exports of goods now constitute barely a majority of their total exports due to the rapid growth of 'invisible' earnings from tourism, offshore banking and other financial services and workers' remittances.

Dependence on foreign resource flows

4.12 Various studies have shown that small countries experience a larger (net) transfer of foreign resources (as measured by the deficit on trade in goods and non-factor services) relative to GNP than larger countries. They also enjoy relatively greater resort to public concessional finance which assists in holding down their debt-servicing burdens. However, small countries are more constrained in their access to the world's fast-growing sources of private finance. Small countries' high degree of 'openness' on the capital account, whilst to some degree beneficial in enabling them to absorb foreign resources, makes them vulnerable to capital flow instability.

Limited capacity to manage the economic environment

4.13 Because of their openness on both trade and capital accounts small countries are both vulnerable to economic shocks originating from abroad and find it difficult to offset them through national macroeconomic management. In a situation where imports satisfy such a large share of domestic spending, small countries have little control over the domestic price level. Sudden dramatic changes in prices for imports or exports will be quickly transmitted to domestic activity levels causing considerable fluctuations in income unless

some form of stabilisation is available to cushion their effect. Similarly, withdrawal of official finance can, through cuts in the development budget and even current spending, impart major depressive effects on the level of activity.

4.14 Insulation from such external shocks can, in principle, be achieved by a flexible exchange rate. But, in a highly open economy, large exchange rate fluctuations produce big internal price and cost disturbances. Small countries, therefore, tend to peg their exchange rates to the currencies of their main trading partners and some even adopt their currency. While there can be economic gains from such a strategy there is also clearly loss of policy autonomy with the added risk that the small state exposes itself to exchange rate fluctuations stemming from fluctuations in the value of the dominant currency.

4.15 In countries with a fixed exchange rate and without capital controls, there is little scope for monetary policy to affect prices and quantities in the non-traded sector of the economy. Thus, the impact of an expansionary monetary policy, through lowering interest rates, may be offset by induced capital outflow (and lower remittances) and have little impact on levels of economic activity. Similarly, a contractionary monetary policy may be offset by capital inflow. Where small countries adopt currency boards or allow a foreign currency to circulate as the domestic medium, they shed their last vestiges of monetary autonomy.

High international transport costs

4.16 The majority of small developing economies are island states and three of them in Southern Africa are landlocked. Because of the relatively small volumes of cargo carried, as well as the remoteness of island economies and the difficult terrain of landlocked economies, small countries suffer high international transport costs per unit value of goods transported. This has the effect of increasing domestic costs of consumption and production and the cif (cost-insurance-freight) delivery price of exports relative to competitors. Small states on average pay 10% as freight costs against the global average of 4.5% and 8.3% for all developing countries. This represents a further impediment to successful economic development which small island states, in particular, are unable to effectively counter given their limited bargaining power with the shipping lines and the prohibitive costs of establishing their own merchant marines.

The Recent Economic Performance of Small States

4.17 In spite of these constraints, the empirical evidence shows that the economic performance of small developing countries since 1980

has been no worse than that of larger countries – indeed, if anything, slightly superior. This suggests either that the obstacles mentioned earlier are not so serious or that small developing states found ways of overcoming or compensating for them. Another possibility is that large countries were affected by adverse developments since 1980 not shared to the same degree by small countries. Indeed, one obvious factor stands out: namely, the developing country debt crisis, as a result of which for many countries the 1980s were a 'lost decade' in terms of economic progress and, for others, even worse, a period of considerable regression. Small countries, failing to gain access to private bank credits in the 1970s, escaped the worst effects of the crisis and painful adjustment in the 1980s.

4.18 At the same time, empirical evidence also suggests that per capita GDP growth is subject to wider fluctuations in small developing states relative to large states, although there is clearly a very considerable degree of variation in fluctuations between countries which is not accounted for by population size. Uganda, a medium sized country, exhibits very high fluctuations as do large countries such as China and Bangladesh. These cases suggest that important sources of economic instability, such as political upheaval, policy switches and natural disasters cannot be ignored. The impact of the latter on SIDS is a matter of record.

4.19 Finally, note must be taken of the many and varied sources of economic growth in small states. Traditional primary products exports are still proportionately large in many countries' export receipts and though of diminishing importance have served as significant sources of employment in the agricultural sector. Remittances remain important for some states and logging and mineral extraction continue to be a source of economic growth, although of late there has been considerable concern expressed about the sustainability of such activity. Some countries recorded manufacture export-oriented growth, particularly in clothing and textiles. Others saw particularly rapid growth in tourism and in offshore banking, insurance and other services. All this suggests that while smallness does limit the capacity to transform such economies it is not an insuperable obstacle to diversification and development. Similarly, openness can be a source of advantage as well as vulnerability.