The small states of the European Union and the resilience/competitiveness nexus

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Abstract: This article places the European Union (EU) small states within the Vulnerability and Resilience Framework, and tests the correlation between economic resilience and competitiveness. In this analysis, economic resilience is associated with good economic, social and political governance, and economic vulnerability is associated with exposure to external shocks, mostly due to a high degree of trade openness. The findings indicate that (a) that the EU small states tend to exhibit a high degree of economic vulnerability, suggesting that they are highly exposed to external shocks and (b) that the most economically vulnerable EU small states tend to register relatively high resilience and competitiveness scores. This would seem to suggest that economic resilience and competitiveness are related and that their policy framework enables them to withstand or reduce the harmful effects of their exposure to economic shocks.

Introduction

This article places the European Union (EU) small states – defined as those with a population of about three million or less – within the Vulnerability and Resilience Framework, proposed in Briguglio (2016). In this study, economic resilience is associated with good economic, social and political governance; while economic vulnerability is associated with exposure to external shocks, mostly due to a high degree of trade openness. A conclusion that emerges from Briguglio (2016) is that, in spite of their high degree of economic vulnerability, a number of small states register relatively high GDP per capita, possibly because of their sound economic governance, enabling them to build a resilience to economic shocks.

In addition, many small states register relatively high competitiveness scores in global databases, in spite of their economic constraints, including their limited ability to reap the benefits of economies of scale. This chapter, building on Briguglio (2018), assesses whether there is a link between economic resilience and competitiveness in the small states of the EU.

The rest of the article is laid out as follows. Section 2 describes the Vulnerability and Resilience Framework in order to assess where the EU small states fit within it. Section 3 analyses the relation between competitiveness and economic resilience, exploring where the small states of the EU fit within this association. The third section discusses a suite of implications for small states that follow from the previous sections. Section 4 concludes.

**The Vulnerability and Resilience Framework**

Inherent economic vulnerability

Small states tend to be highly exposed to external economic shocks because of their inherent features, mostly associated with trade openness. This is the result of their small domestic market compelling such states to be highly dependent of exports for survival. In addition, their limited natural resource endowments lead such states to depend highly on imports. Small economies that do not sufficiently engage in international trade are likely to be weak economic performers. The exposure to external shocks, arising from small states' high degree of dependence on international trade, tends to be worsened by a high export concentration and high dependence on strategic imports, including food, fuel and industrial supplies.

Economic vulnerability is associated with:

(a) trade openness, exposing the economy of a country to external shocks. This is not a matter of policy choice: small states must export a high proportion of their sales and import a large proportion of their requirements in order to survive;

(b) export concentration, which exacerbates an open economy's exposure to shocks. Again. this is an inherent feature of small states due to their limited diversification possibilities;

(c) dependence on strategic imports, such as food and fuel, which are very price and income inelastic and which also exacerbates an open economy's exposure to shocks; and

(d) proneness to natural disasters, which leads to economic shocks and exacerbate the effects of external shocks (Briguglio et al., 2009; Briguglio, 2016).

Briguglio (2016) constructed an Economic Vulnerability Index composed of these four variables. Figure 1 shows this Index, scaled from 0 to 1, plotted against country size, measured by population, for 186 countries. The scatter diagram confirms that small states tend to be more economically vulnerable than other groups of countries.

**Figure 1: Economic vulnerability and country size: 186 countries.**
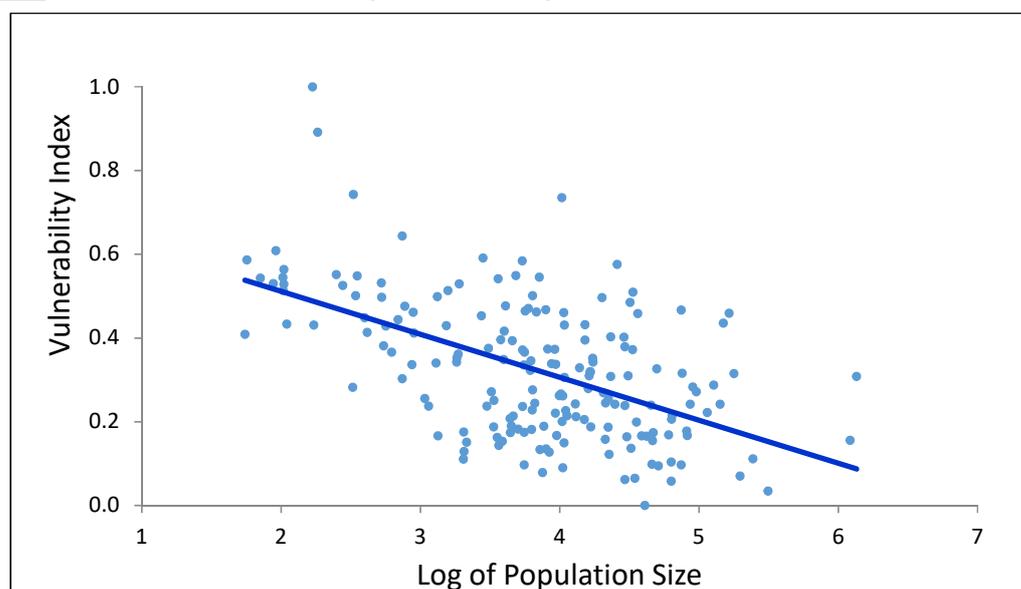
In the present study, we applied the same procedure to the EU small states and found that the negative relationship also occurs in the case of these states - as shown in <u>Figure 2</u> - as well as in the case of the 28 EU member states, as shown in <u>Figure 3</u>. Three EU candidate small states – Albania, Macedonia and Montenegro – are included in the graphs. This suggests that the smaller EU member states tend to be more exposed to external shocks than larger ones.

Figure 2: **Vulnerability and Population: EU 7 Small States + 3 Candidate Small States.**
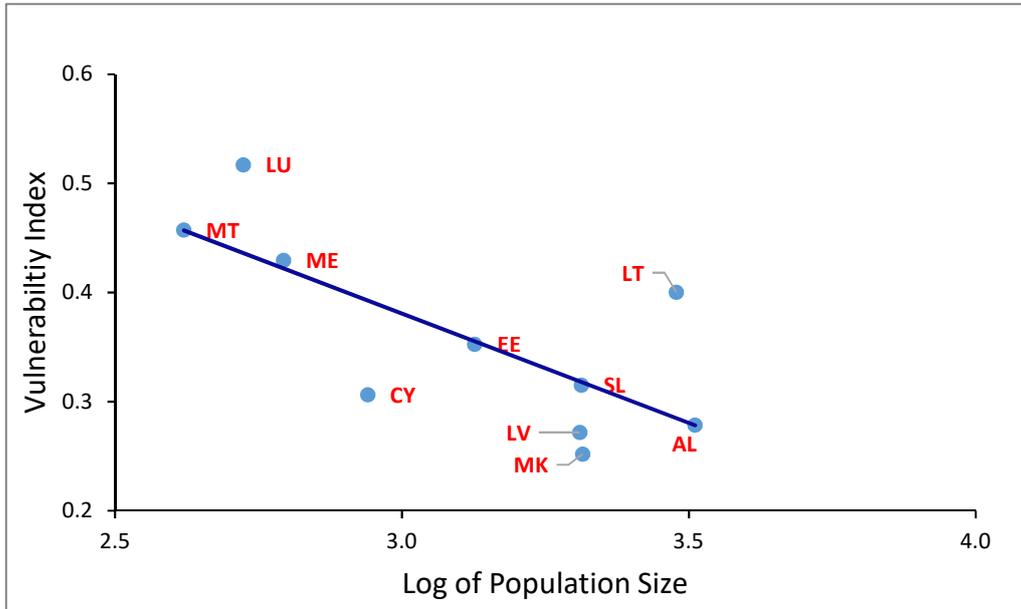
Figure 3: **Vulnerability and Population: EU 28 + 3 Candidate Small States.**
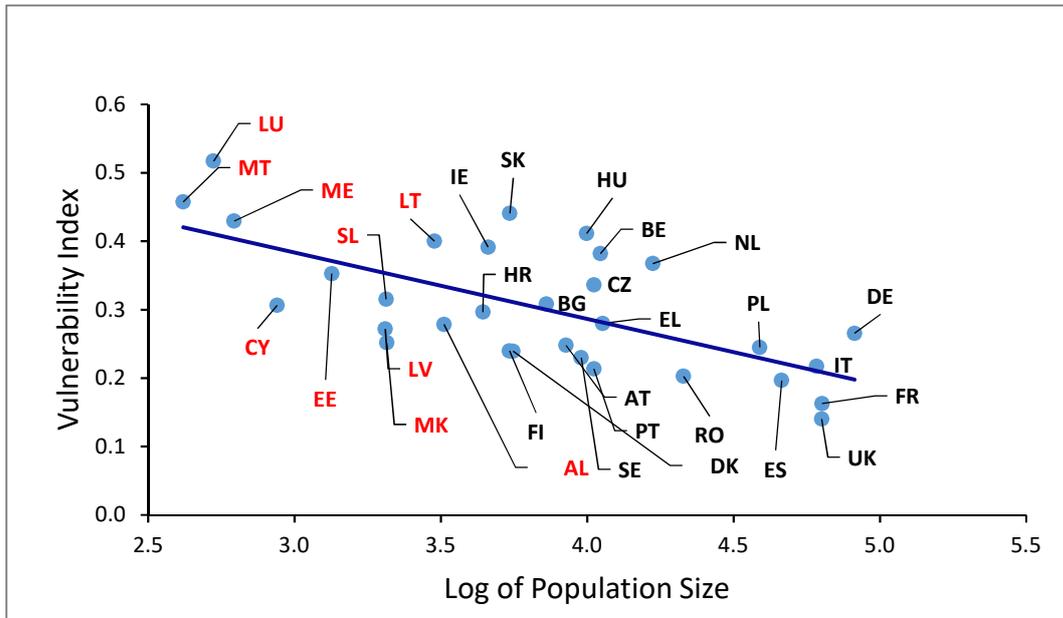
Economic Resilience

Briguglio (2016) associated economic resilience with policy measures that enable a country to withstand, absorb or bounce back from the harmful effects of external shocks which result from economic vulnerability. The relevant policy measures identified are those linked to:

   (a) macroeconomic stability, which allows policy manoeuvre following an external shock;

   (b) prudent market flexibility, which enables the economy to adjust after an external shock (prudence refers to due diligence to avoid excess financial risk and market abuse);

   (c) sound political governance, essential for an economic system to function properly;

   (d) social development and cohesion, which allows the economy to function without the hindrance of civil unrest; and

   (e) environmental management, which generates stability through enforceable rules economic instruments and moral suasion.

The author constructed a composite index based on these five variables, which he termed an "economic resilience index".

The author found no link between the economic resilience index (ERI, scaled between 0 to 1) and country size; but found a strong correlation between ERI and GDP per capita, as shown in Figure 4, suggesting that developed countries tend to be better able to withstand external shocks. Resilience scores were not found to be related to country size: this means that small as well as large countries can register high ERI scores.

**Figure 4: Economic resilience and GDP per capita.**
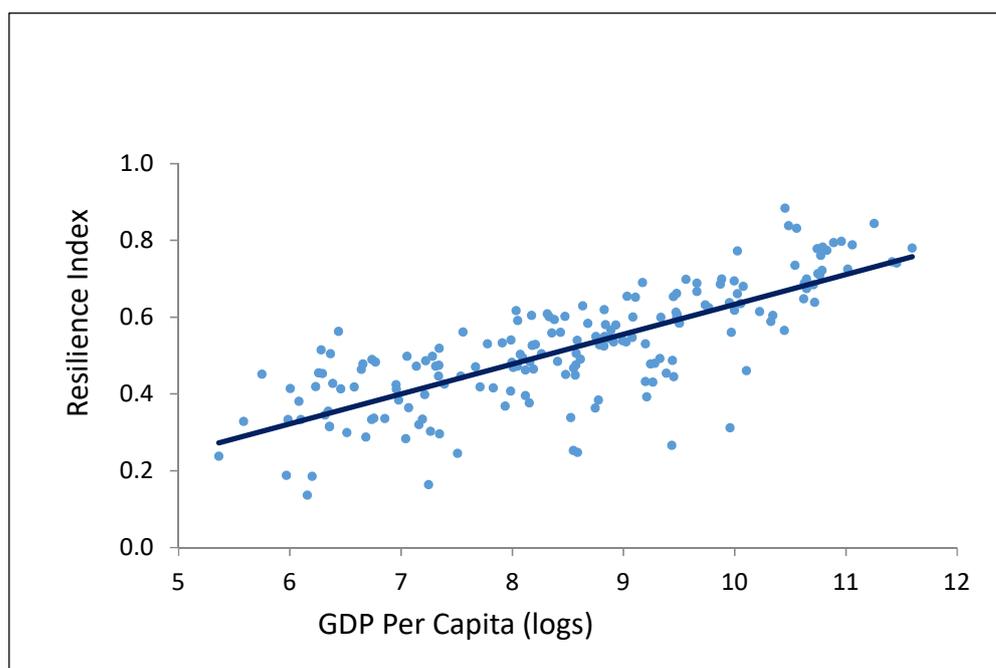
In the present study, it was found that the same tendency occurs in the EU members plus 3 applicant states, as shown in <u>Figure 5</u> and <u>Figure 6</u>, where there is a clear correlation between the resilience index and GDP per capita.

<u>Figure 5</u>: Resilience & GDP Per Capita: EU 7 Small States + 3 Candidate Small States.
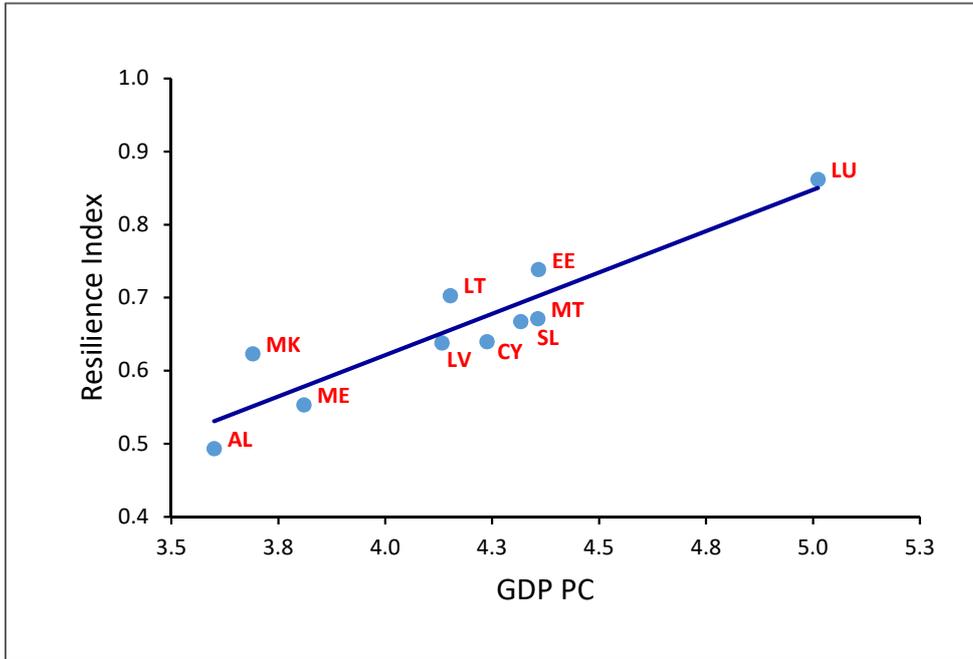
<u>Figure 6</u>: Resilience and GDP Per Capita: EU 28 + 3 Candidate Small States.
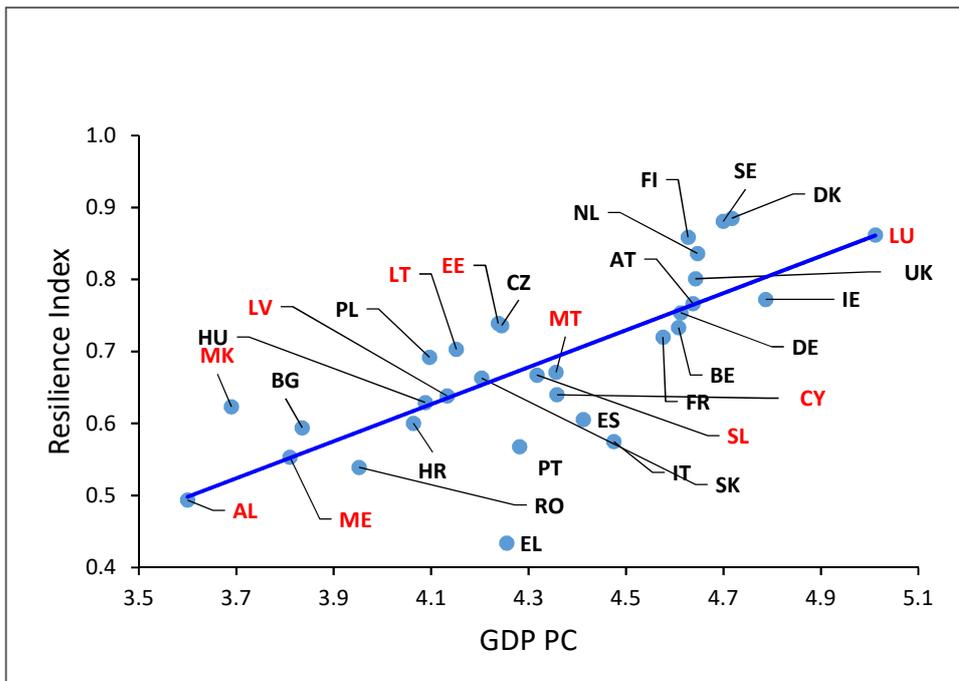
*Juxtaposing the Vulnerability and the Resilience Indices*

The Vulnerability and Resilience (V&R) Framework developed in Briguglio et al. (2009) and Briguglio (2016) is summarised in Figure 7. The V&R Framework deals with the risk of an economy being harmed by external economic shocks. In brief, the risk of such harm increases as vulnerability increases; and it decreases as resilience increases. It should be recalled that, according to the V&R Framework, economic vulnerability is associated with inherent conditions that expose a country to shocks, while resilience is associated with policy-induced measures that enable a country to reduce the harm of external shocks (Briguglio, 2016).

The V&R Framework can be quantified and represented by a scatter diagram with vulnerability index on one axis and the resilience index on the other, as shown in Figure 8. This figure utilises Briguglio (2016) data for 186 countries. On the basis of the results obtained from the quantification of the V&R Framework, Briguglio (2016) classified countries into four groups as shown in Figure 9.

Figure 7: The Vulnerability and Resilience Framework.
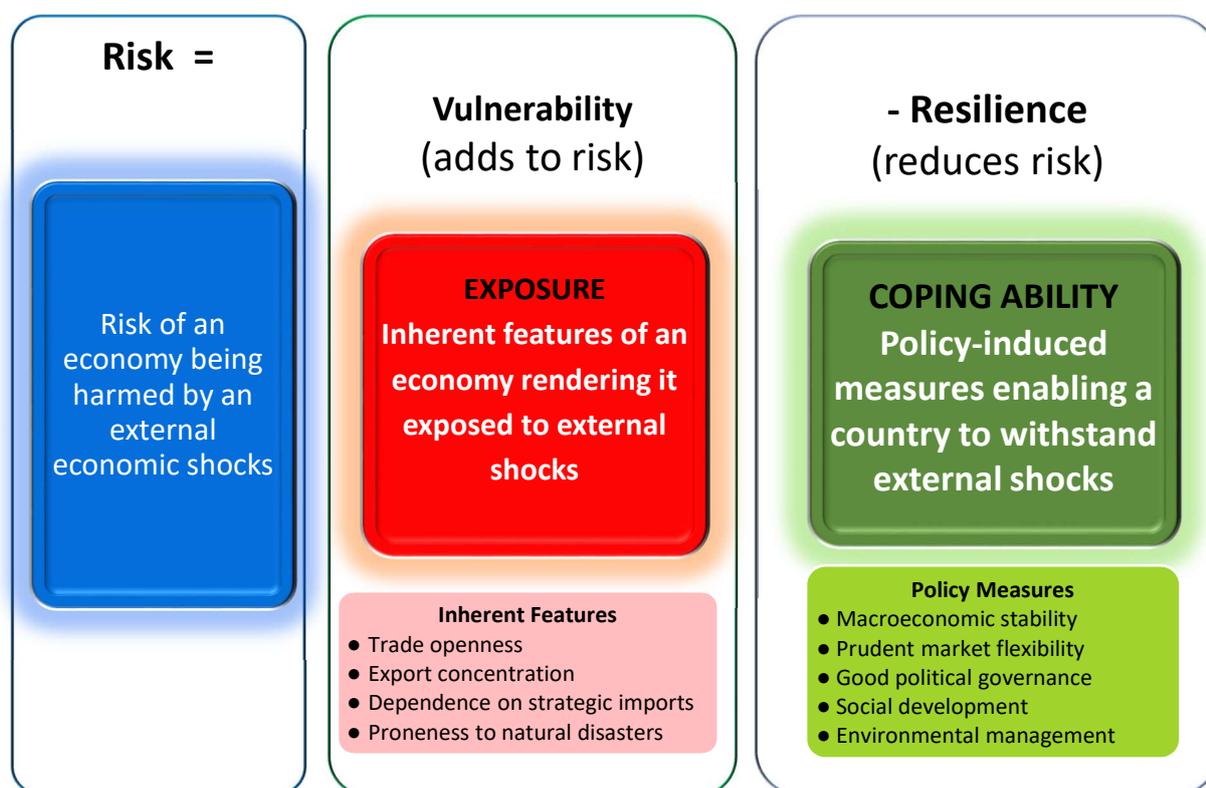
Figure 8: The place of the EU member states within the V&R Framework.
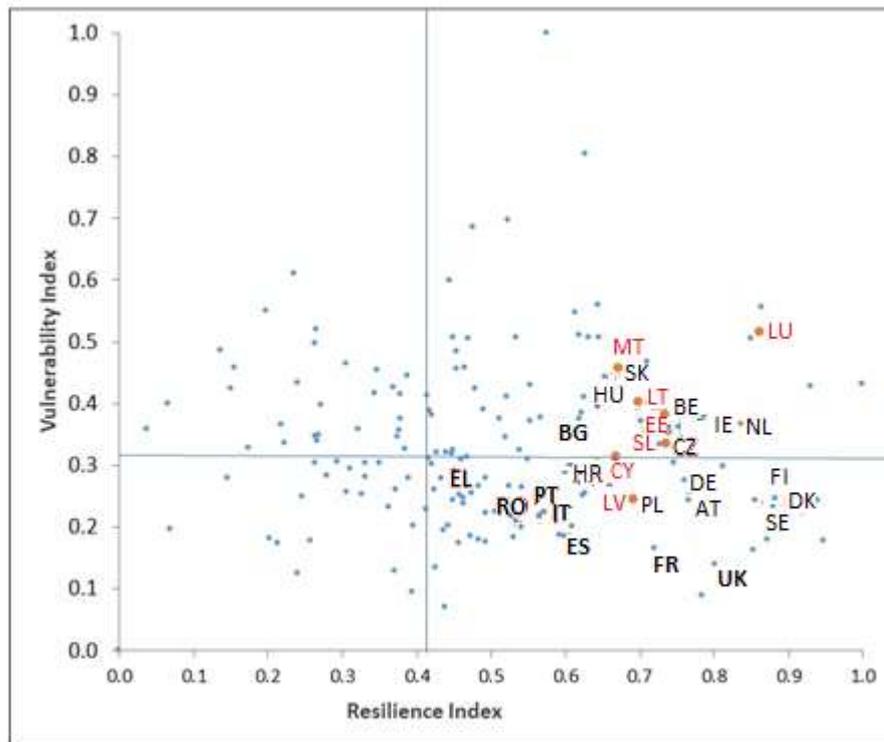
Figure 9: Four Country Scenarios
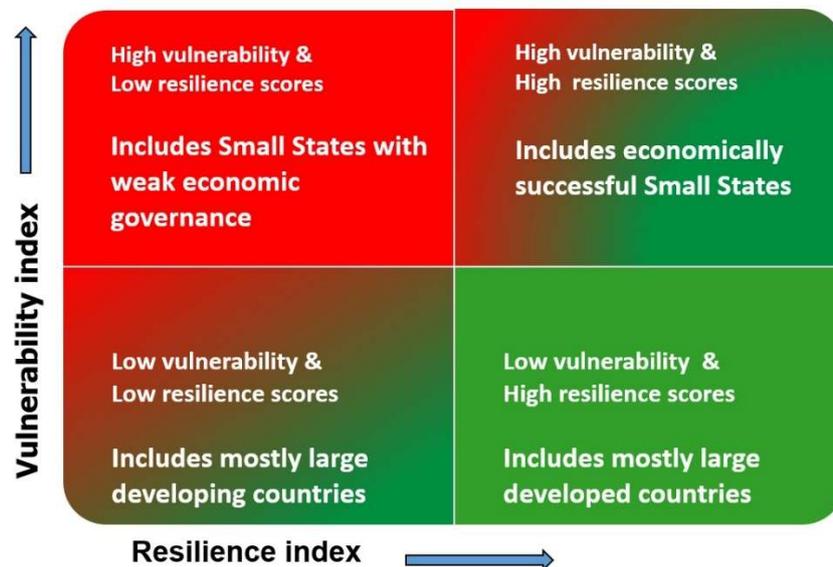
It can be from Figure 8 that the EU member states exhibit relatively high resilience scores, with the smaller states registering relatively high vulnerability scores. Going by the classification shown in Figure 9, most of the small states of the EU would fit in the top-right quadrant of the diagram.

Small States and Competitiveness

In a globalised free trade context, competitiveness is the means for firms as well as for countries to survive and thrive. The alternative to competitiveness, namely protection from competition, has, time and time again, proved to be futile as it results in inefficiencies and poor returns.

Small states are characterised by a number of special features which tend to constrain their competitiveness:

a) limited ability to exploit economies of scale;

b) high per capita cost of public administration due to indivisibility of overhead costs;

c) limited possibilities of diversification;

d) limited domestic competition due to the ease of monopolising a small market; and

e) Being price-takers and unable to influence international prices of industrial supplies and other imports.

Competitiveness, however, is especially important for small states because of their very high dependence on international trade, resulting from their small domestic markets.

The Global Competiveness Report defines competitiveness as the set of institutions, policies, and factors that determine the level of productivity of a country. The issue of productivity features in most studies on competitiveness. Porter (2003, p. 22) defines competitiveness in a similar manner as "the productivity with which a nation utilizes its human, capital and natural resources". According to Porter (2003, p. 3), competitiveness is related to a nation's prosperity, which in turn is determined by the productivity of its economy, measured by the value of goods and services produced per unit of its resources.

Briguglio (2018) defined sustainable competitiveness as the ability of an entity (firm, economic sector or the whole economy) to supply a good or a service by combining price and quality, with due respect to the environment and workers' dignity, in such a manner that buyers would prefer to buy such good or service from the said entity, when similar goods or services are supplied by other entities. According to this definition, being able to reduce prices by disregarding the environment or by exploiting employees or by dumping products, is not the manner in which competitiveness can sustainably be attained.

Competitiveness is multi-faceted, spanning economic social political and environmental dimensions and involves various stakeholders. The achievement of competitiveness across all these dimensions in a sustainable manner will depend upon appropriate economic, social and environmental policies, as well as an appropriate institutional set-up.

The multi-faceted character of competitiveness is emphasised in the Global Competitiveness Reports. For this reason, the report measures competitiveness of countries on the basis of 12 pillars, namely:

| Institutions	Infrastructure	Macroeconomic environment
Health and primary education	Higher education and training	Goods market efficiency
Labour market efficiency	Financial market development	Technological readiness
Market size	Business sophistication	Innovation

UNIDO (2013) defines competitiveness in terms of an environment characterised by a conducive regulatory environment, appropriate market information, adequate institutional and technical support infrastructure that enable, knowledge and skills on the side of entrepreneurs.

Briguglio and Cordina (2004) argue that competitiveness is, to a large extent, an enterprise issue and it is the individual firm at the micro level that needs to be competitive in order to enhance national competitiveness. However, they further argue that the government has a major role to play in this regard not least by placing competitiveness high on the policy agenda and taking the lead in (a) putting in place measures that encourage entrepreneurship and efficiency and (b) removing bottlenecks when these occur.

The Resilience/Competitiveness Nexus

In the 2016/17 Global Competitiveness Index, produced by the World Economic Forum the overall score of the EU small states are below the average of the EU28 as shown in Figure 10. The EU small states registered lower scores with regard to market size, infrastructure, higher education and training, financial markets, technological readiness, business sophistication, and innovation. It should be noted that the GCI is somewhat biased against small states as it gives a 6% weight to market size.

Figure 10: GCI scores for the EU small states (SS) and for all EU member states (All).
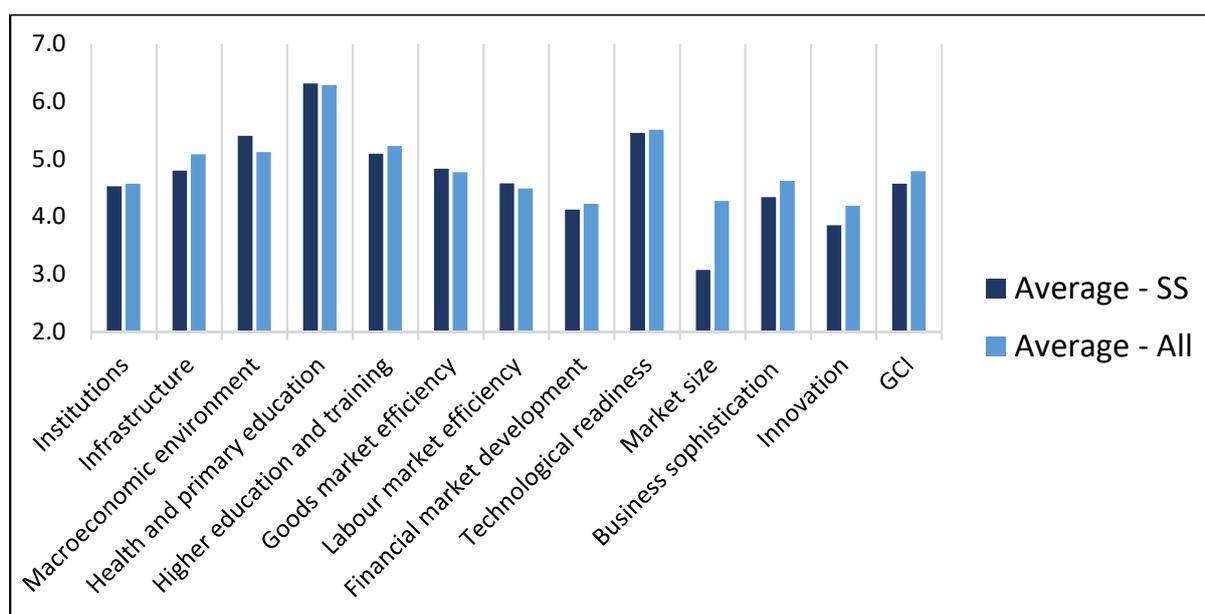
However, in some of the pillars notably Macroeconomic Environment, Higher Education and Goods/Labour Market Efficiency, the EU small states tended to have better scores than the average of the EU 28.

Positive relationship between ERI and GCI

There is a significant positive correlation between the Economic Resilience Index (ERI) as calculated in Briguglio (2016) and the 2016-17 Global Competitiveness Index, as shown in Figure 11 which relates to the 140 countries covered by the GCI. As can be seen from Figure 12, this pattern is, by and large, replicated in the case of the 28 EU member states and, from Figure 13, in the case of the EU small member states and applicant small states.
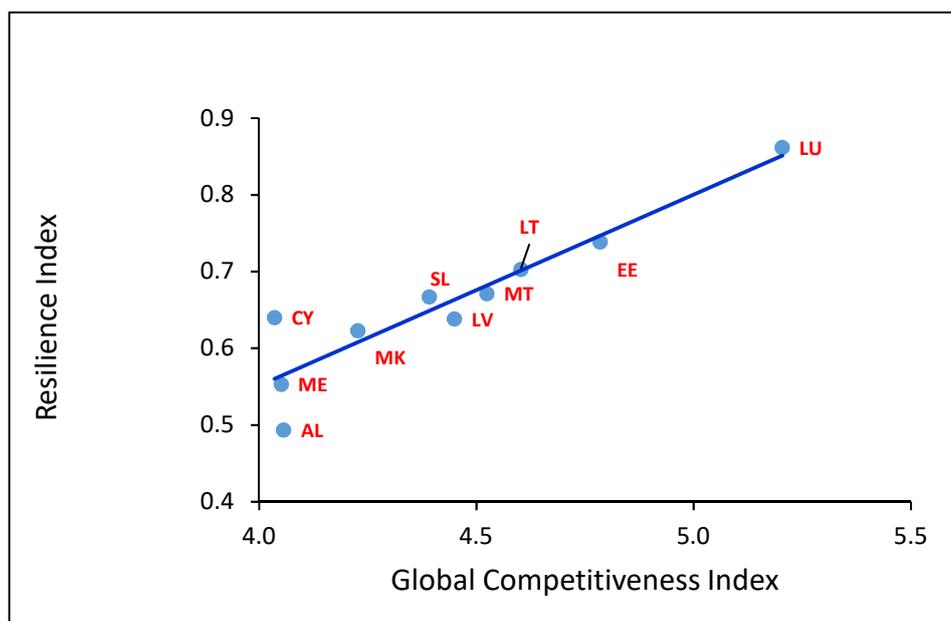
Figure 11. The relationship between the GCI and the ERI.
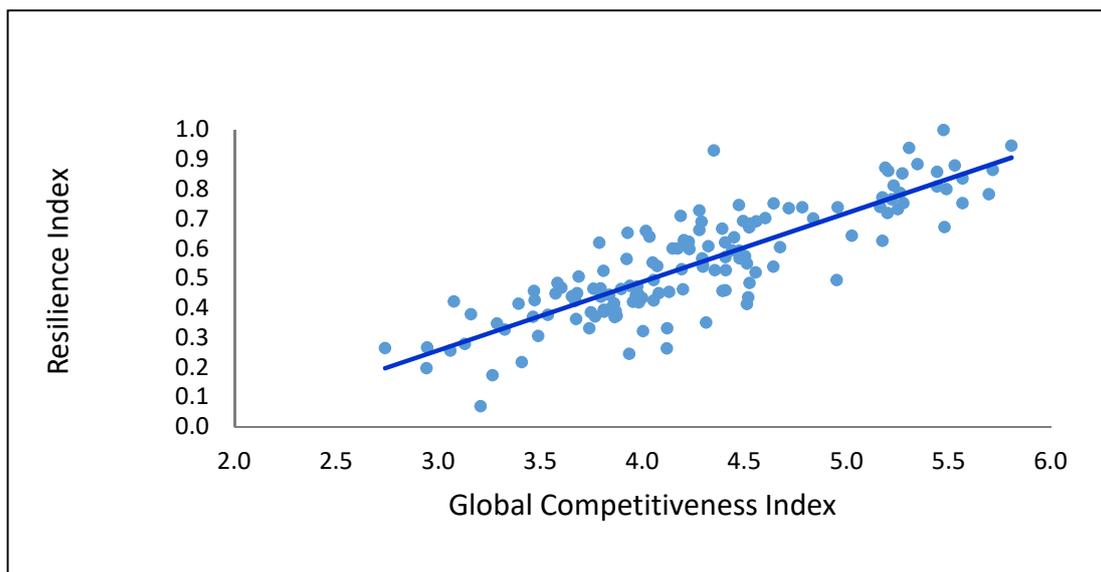
Figure 12. Resilience and Competitiveness: EU 28 + 3 Small Candidate States.
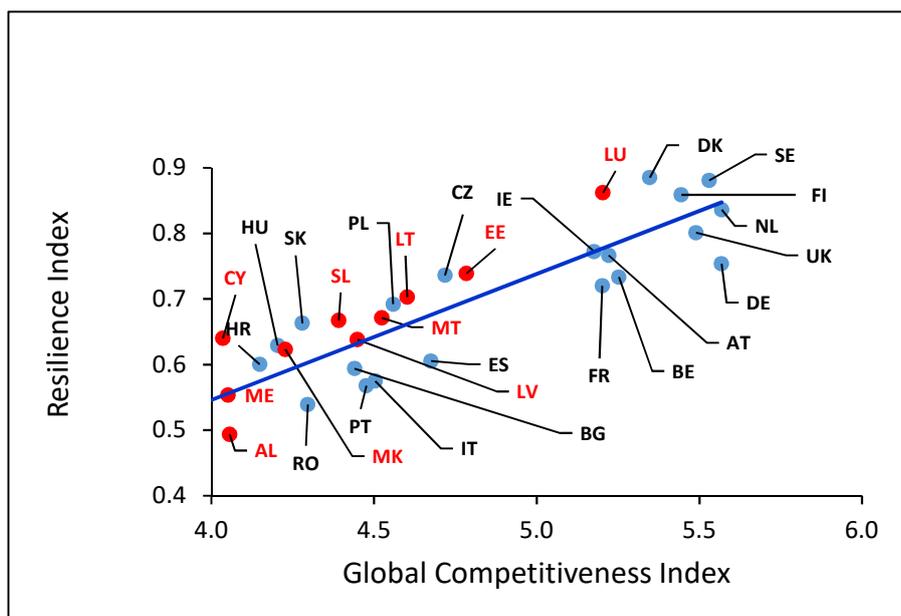
Figure 13: Resilience & Competitiveness: EU 7 Small States + 3 Candidate Small States.

Note that the GCI has a few indices which are also found in the ERI (such as macroeconomic stability), but most of the 114 indicators of the GCI are not included in the ERI (which consists of five indicators). In addition, and more importantly, the sources of the data are very different. In the case of the ERI, the sources are global databases available in the public domain, compiled by the IMF (for macroeconomic stability), Fraser Institute (for market flexibility), UNDP (for social development), World Bank (for political governance) and Yale University (for environmental management). On the other hand, the vast majority for the GCI indicators are derived from the so-called Executive Opinion Survey, conducted by the World Economic Forum, based on perceptions of over 14,000 business executives in 138 economies (Browne, 2016).

Implications for small states

As argued earlier on in this chapter, small states tend to be highly economically vulnerable to external shocks mostly as a result of their high degree of trade openness. For this reason small states, more than other groups of countries, need to have a resilient economy. Resilience building also enhances small states' competitiveness as these two variables are both underpinned by good economic governance and are in fact highly correlated, as shown earlier in this chapter. It follows that it pays small states to embed resilience-building measures in their plans and strategies. These measures also enhance their competitiveness.

Identifying niche linkages

While small states need to be competitive in view of their high reliance on exports, due to their small domestic market, they face serious constraints in this regard. As a result, they generally find it very difficult to compete in manufactured and agricultural products particularly those that can be produced cheaply by mass production. In areas where mass production is not an important factor, such as financial services and tourism, small states often manage to compete with larger countries.

However small states can identify niche manufactured and agricultural products as linkages to their services sector. This is particularly possible in the tourism industry which requires fresh food inputs. There may even be a market for light industry tied to the tourism sector, provided that this can compete in price and quality with imported manufactured products.

Creating linkages through clustering

Linkages between different stages of production and between different production entities can be enhanced through clustering at the domestic and regional levels. A cluster is a concentration of interconnected businesses which can benefit horizontally through such linkages as sharing resources and innovation networks as well as vertically by such linkages as joining a supply-chain and sharing outlets. Wignaraja et al. (2004) argue that clustering requires sophisticated governance and appropriate institutional set-ups, which may be lacking in the case of many small states and therefore external support might be required for this purpose. In the case of the EU small states, such support can be obtainable through EU funds.

Clustering can also be applied at the regional level (group of countries in a given geographical location) to reap what may be called regional externalities including soft externalities such as sharing of knowledge and hard externalities in terms of availability of particular resources. As an example, in the case of the EU small states, there is an attempt to do this in medicine (Espín et al., 2017).

Such regional clustering would also reduce duplication efforts by small states who would economise on overhead costs. A number of small states of the EU are already benefitting from such synergies in the field of health systems and policies in small states, under the auspices of the World Health Organisation (Azzopardi Muscat et al., 2016).

Singapore may provide a good example of the usefulness of industry clusters in a small state. As Yue (2005) argues, Singapore's industrial strategy is all about identifying industry clusters to be nurtured. One outcome of such a strategy is that Singapore has developed a leading electronics hub. The strategy was aimed at upgrading capabilities across the value chain in each industry cluster, mainly by identifying gaps and formulating initiatives to close them, by among other things establishing the Cluster Development Fund and promoting joint ventures between local enterprises.

Attraction of investment

Another benefit that competitiveness and resilience building could generate for small states relates to the attraction of foreign direct investment (FDI). FDI tends to be attracted by countries which have a large domestic market and natural resources endowments. Small states tend to be highly disadvantaged in this regard. Good economic governance, which lead to competitiveness and resilience could, to some extent, make up for these inherent deficiencies, and can act as attractions for FDI.

Conclusion

The findings presented in this paper indicate that the small EU member states exhibit a relatively high degree of economic vulnerability, resulting mostly from their high dependence in international trade, rendering them highly exposed to external shocks. However, they also exhibit a relatively high degree of economic resilience, associated with policy measures that are conducive to stability. Another finding is that the most economically vulnerable small EU member states tend to register relatively high competitiveness scores. This would seem to suggest that economic resilience and competitiveness are related in that, while these small states are highly exposed to shocks, their policy framework enables them to withstand or reduce the harmful effects of their exposure to such economic shocks.

An important message of this chapter is that while it is true that small states tend to be economically vulnerable and face competitiveness constraints in view of their small size, this reality should not be construed as an argument for complacency on the part of small states because remedial policy options are possible for these states.

Disclaimer

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