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DEVELOPMENT CHALLENGES FOR SMALL OPEN ECONOMIES OF THE COMMONWEALTH

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Abstract. Twenty-two of the 53-member Commonwealth, comprising developed and developing nations, are nation states with populations less than one million. The chapter shows that size creates problems peculiar to these small states compared to their larger counterparts. However, cross-country evidence shows that well-managed small economies have outperformed both poorly managed small states as well as much larger states. It is argued that the secret of success lies in the small states capabilities for speedy adjustment to external shocks. The chapter refers to the argument that since some small states have done well, small states have small problems. The chapter contends that this argument is flawed. It is proposed that the successes of small states deserve closer scrutiny so that they can be replicated elsewhere. The challenge for policy makers, therefore, is to draw lessons from the successes and emulate these within the less successful economies.

1. Introduction

This chapter considers development challenges for small open economies within the Commonwealth. Twenty-three of the 53-member Commonwealth comprising developed and developing nations are made up of nation states with populations less than one million.[1] This voluntary association of independent sovereign states spreads over every continent and ocean. Its 1.8 billion people account for 30 percent of the world's population, but contribute only 12 percent of world output. As shown in Table 1, the spread of per-capita income across this family of nations is large. The average per-capita GDP for the citizens of the Commonwealth as a whole for 2001 was $4125, which is deceivingly high given the range of approximately $27,000, starting from $470 for Sierra Leone and ending at $27,130, for Canada. Life expectancy at birth, similarly, ranges from a high of 79

[1] On the definition of small states see http://wbln0018.worldbank.org/html/smallstates.nsf?OpenDatabase .

Table 1
Basic statistics on Commonwealth Countries (2001)

	Population ('000s)	GDP (US$) (million)	GDP per capita (PPP, US$)	Illiteracy (% of adult population)	Life Expectancy (years)	Open -ness[b] (%)
Antigua and Barbuda	68	682	10170	..	..	49
Australia	19387	368730	25370	..	79	35
Bahamas, The	310	..	..	5	70	..
Bangladesh	133350	46706	1610	59	62	32
Barbados	268	2757	15560	0	75	..
Belize	247	805	5690	7	74	71
Botswana	1695	5196	7820	22	39	92
Brunei	344	..	..	8	76	..
Cameroon	15197	8501	1680	28	49	42
Canada	31082	694480	27130	..	79	70
Cyprus	761	9131	21190	3	78	..
Dominica	72	263	5520	..	76	65
Fiji	817	1684	4850	7	69	85
Gambia, The	1341	390	2050	62	53	54
Ghana	19708	5301	2250	27	56	89
Grenada	100	398	6740	..	73	57
Guyana	766	699	4690	1	63	152
India	1032400	477340	2840	42	63	20
Jamaica	2590	7784	3720	13	76	59
Kenya	30736	11396	980	17	46	25
Kiribati	93	40	..	..	62	150
Lesotho	2062	797	2420	16	43	121
Malawi	10526	1749	570	39	38	49
Malaysia	23802	88041	8750	12	73	184
Maldives	280	584	..	3	69	80
Malta	395	3623	13160	8	78	72
Mauritius	1200	4500	9860	15	72	78
Mozambique	18071	3607	1140	55	42	49
Namibia	1792	3100	7120	17	44	95
Nauru	12	..	5000	..	62	..
New Zealand	3849	50425	19160	..	78	54
Nigeria	129870	41373	850	35	46	27
Pakistan[a]	141450	58668	1890	56	63	34
Papua New Guinea	5253	2959	2570	35	57	97
Samoa	174	255	6180	1	69	57
Seychelles	82	570	..	..	73	104
Sierra Leone	5133	749	470	..	37	26
Singapore	4131	85648	22680	7	78	278
Solomon Islands	431	265	1910	..	69	75
South Africa	43240	113270	11290	14	47	51
Sri Lanka	18732	15911	3180	8	73	68
St Kitts and Nevis	45	343	11300	..	71	60
St Lucia	157	662	5260	..	72	49
St Vincent/Grenadines	116	353	5330	..	73	64
Swaziland	1068	1255	4330	20	45	131
Tokelau	1	1.5	1000	..	69	..
Tanzania	34450	9341	520	24	44	26
Tonga	101	142	..	..	71	73
Trinidad and Tobago	1310	8842	9100	2	72	93
United Kingdom	58800	1424100	24160	..	77	42
Vanuatu	201	213	3190	..	68	39
Zambia	10283	3639	780	21	37	50
Zimbabwe	12821	9057	2280	11	39	37

[a] Pakistan, following a military coup in October 1999, was suspended from the Commonwealth.
[b] Openness is the ratio of goods and services trade to GDP.

Source: *World Development Indicators* via the International Economic Database (IEDB), The Australian National University, Canberra. Data for Nauru sourced from http://www.cia.gov/cia/publications/factbook.

years for Australia and Canada to a low of 37 years for Sierra Leone. The size of economies, however defined, is just as diverse with the smallest nation of Nauru having a population of 12,000 versus that of one billion for India.

The objectives for this chapter are (i) to highlight the challenges for development faced by policy makers of small open economies; and, (ii) to offer policy recommendations to mitigate some of the adverse consequences of smallness. The rest of the chapter is organised as follows. The next section deals with the major development constraints faced by small states. Section 3 proposes a number of policy options for SIDS, given the constraints discussed in section 2. In particular, it is proposed that it is imperative for small states to develop the capabilities for faster adjustment to shocks. Section 4 deals with the role of the Commonwealth. Section 5 concludes the chapter by referring to the argument that since some small states have done well, it follows that small states have small problems. It is argued that this argument is flawed. It is proposed that the successes of small states deserve closer scrutiny so that they can be replicated elsewhere.

2. The Development Challenges of Small States

Development is defined here as improvements in the quality of life; the common indicators of such improvements include increases in income and life expectancy for the population as a whole. The national averages for these two statistics, and that of life expectancy in particular, provide a reasonable approximation of the dispersion of the quality of life within the population. This is because the elite in each country experience approximately the same quality of life such that poorer country averages are driven by the skewness of income distribution towards the poor.

Many of the factors important to development are identical for both large and small countries. For example, the critical ingredients for development in terms of a stable economic environment, clear and enforceable property rights, good public infrastructure, an open trading environment, and an accommodating international trading environment are common to both small and large open economies.

There is growing consensus on the ingredients and recipes for sustained growth of economies. Such growth, it is argued, occurring within a competitive environment—in the literature this is termed "quality growth" (see Rodrik, 1999)—leads to commensurate increases in per-capita income leading to improvements in the quality of life of the general population. The development challenge, therefore, is to raise growth of output under competitive conditions: this challenge is no different for small and large economies.

Constraints faced by Small States

Due to their greater openness, small economies are more exposed than large countries to external shocks. This fact, combined with their use of fixed exchange rate regimes (to reduce the volatility of their domestic currency given thin capital markets), limits the effectiveness of monetary policy in macroeconomic stabilisation. Their size also limits the use of discretionary trade policy for improvements in domestic welfare. Given the need to maintain credibility of the domestic currency, exchange rate policy—the use of devaluations in particular—is used sparingly and only in extreme situations. Fiscal policy, as a consequence, is the major tool for economic management in small open economies.

Small isolated states face several problems that have the potential to constrain economic activity. Most of these disadvantages emanate from lack of economies of scale, often implying the lack of a sufficiently large population and domestic resource base to allow production of goods and services at the minimum efficient scale. The problems of isolation, for example, raises transportation cost that imposes a competitive disadvantage on commodity exports. A high degree of specialisation follows from efforts to secure economies of scale in production, marketing, transportation, and distribution. Industries that are established tend to be those requiring minimal economies of scale such as small-scale agriculture, boutique tourism, and assembly activity such as clothing. Some import competing industries survive due to a combination of high levels of protection, public sector subsidies, and presence of large resource rents that fund downstream processing.

The lack of scale economies could be a serious handicap to growth since recent developments in endogenous growth theory suggest that scale is necessary for growth-enhancing activities, including research and development (R&D) and learning-by-doing (see Romer, 1986; Lucas, 1988; Barro and Sala-I-Martin, 1995; and Aghion and Howitt, 1998). But, the greater concentration increases exposure to movements in international prices and quantity shocks such as those arising from adverse natural consequences that in turn are manifested as output and export instability. Examples of the latter include the 1998 taro blight in Samoa that nearly decimated the industry and a severe downturn in tourist arrivals to Vanuatu in 1998 due to hail damage to its lone jet-aircraft.

The narrow resource base of small economies prevents them from satisfying the diverse demands of consumers. Hence, these economies are more reliant on international trade than their larger counterparts. The reliance on a narrow range of export commodities to earn foreign exchange exposes the economies to greater volatility in such earnings due to reduced opportunities for diversification of income from local sources. Hence, supply shocks at home or price shocks from abroad lead to greater volatility in income and demand in small vis-à-vis larger economies. Small economies, by definition, lack market power in the global market place; this is as much a virtue as it is a handicap. While small economies are at the mercy of global commodity prices, they face infinitely elastic demand for their commodity exports.

The jury examining the extent to which the factors listed above have constrained growth in small economies is still out. After extensive empirical testing, Easterly and Kraay (2000) come to the conclusion that smallness is not a disadvantage to development; they argue that on average small states have higher incomes than their larger counterparts. This claim has not gone unchallenged as noted in Blake (2001), but what is clear from several similar analyses is that the constraints for growth of output faced by small states can be overcome; but doing so demands good economic management. Easterly and Kraay (2000) also claim that the ingredients and recipe for growth of production is the same for all countries and suggest that unwarranted attention has been paid to the problems of small states.

Small Size and Development: Four Peculiarities

There is considerable, albeit not total, overlap between development problems faced by small vis-à-vis large economies. The following are four issues peculiar to small states.

First, their small markets are often able to sustain only a few and sometimes only a single local supplier. This thinness of the market confers market power to the incumbent(s), thereby constraining competition—a necessity for achieving efficient allocation of resources. Small economies, consequently, have great difficulties in relying on market forces alone to achieve competitive pricing within utilities, banking, and aviation—that is sectors having significant economies of scale. Regulation is the obvious solution, but the limited capacity to induce competitive behaviour is just as difficult.

Second, an absence of scale economies reduces the range of non-traded services produced by the private sector. This often provides the rationale for public sector participation in commerce. National airlines, shipping companies, and state-run utility companies in small states are rationalised as filling the void left by the private sector. Developing country experience across the globe with state owned enterprises (SOEs) in terms of their profitability, sustainability, and efficiency of resource use has been very disappointing. The poor performance of SOEs acts as a drag on overall economic performance. Moreover, Governments have often "protected" their SOEs thus impeded private sector participation.

Third, the small population of small states limits the pool of available skills including those for economic management. Furthermore, the small size of the population means an even smaller group of elite which hampers "arms length" governance, and therefore creates the conditions for nepotism and corruption: this is what Harberger (1988) calls the tyranny of demography. Poor governance leading to poor economic management penalises development.

Fourth, small open economies tend to peg their domestic currency to the currencies of their major trading partners as a means of minimising exchange rate volatility. When the capital account is open, this policy imposes a cost to economic management by limiting the effectiveness of monetary policy in demand management.[2] Furthermore, downward-rigidity in domestic prices leads to an appreciation of the real exchange rate during periods of adverse terms of trade shocks, thus leading to involuntary unemployment and loss of domestic competitiveness.

In summary, small states have more volatile income and have limited capacity to mitigate the effects of international shocks on domestic production, employment, and prices. The best that these states can do is to learn to cope with and be prepared for such volatility. But, the responsibility remains with the domestic authorities to create an economic environment conducive to quality growth; the international community can only facilitate but not initiate such a process. Some of the policy options available to small states and the Commonwealth to accelerate the pace of development in small sates are considered next.

3. Some Policy Lessons

Given that small states are more exposed to shocks and have limited internal capacity to cushion the impacts of such shocks than larger

[2] Note that in the case of perfect capital mobility with a fixed exchange rate, monetary policy is ineffective in demand management.

counterparts, they need to develop the capabilities for faster adjustment to shocks. This requires increased flexibility in factor and product markets to ensure adjustment costs are minimised. Rapid adjustment to shocks will reduce supply-demand imbalances in markets. Freeing up wage and price controls is, therefore, necessary to achieve the required flexibility. Lowering regulatory barriers to entry into industry and increased investment in education, particularly life-long learning, would also assist in this regard.

To create a more flexible and adaptive economy small states, need to invest heavily in transportation and communications infrastructure, education to build the adaptive skills of their workforce, and institutional reform to remain adaptive to changing circumstances. Investment to enable rapid adaptation to change is costly for small open economies. High transport costs will continue to impose a competitive disadvantage on commodity exports. However, innovations in telecommunications technology combined with continued growth in service exports are reducing the economic disadvantage associated with physical isolation.

Fortunately for small geographically isolated states, telecommunication costs are falling rapidly, while the share of services in GDP is growing with rising global incomes, as demand for services tends to be income elastic. An investor-friendly environment, together with a skilled workforce, should lead to growth of services exports from small isolated states, as this sector faces the least (and declining) cost disadvantage. The challenge for policy makers is to create an environment conducive to investment such that competitive services industries, can "pick themselves out" in a globally competitive environment.

Further opening up to international trade and investment via integration within the global markets through customs facilitation and adoption of common investment and taxation arrangements could provide possibilities one option for risk diversification.[3] Access to the global financial markets provides access to market-based instruments to insure against local risks, including those from volatile export income. Freer access to the global labour markets, particularly by unskilled workers from small states, will provide an effective instrument for macroeconomic adjustment in periods of stress such as those arising from severe terms of trade shocks or major natural disasters. More fluid flow of information through networks between firms in the North with those in the South will also facilitate

[3] The Cotonou Agreement between the EU and ACP countries – the latter comprising a large number of small states – foreshadows such a possibility.

productivity-enhancing knowledge flows. The Commonwealth and the EU can greatly assist in facilitating all of the above.

The initiative for further liberalisation of trade by small states needs to be taken unilaterally and on a most favoured nation (MFN) basis if they are to benefit fully from increased and more liberal global trade. Growth rates in small states located proximately to each other tend to be highly correlated, not least due to similarities in the composition of production and exports and exposure to the same natural disasters such as droughts and hurricanes. It makes little economic sense therefore for small states to form regional economic arrangements: such initiatives are more likely to be "trade-diverting" rather than "trade-creating".

4. The Role of the Commonwealth

The Commonwealth can make a worthwhile contribution in ameliorating problems arising from the small pool of skills and the prevalence of networks that constrain arms-length governance in small states. Encouragement of the freer flow of skills between the family of nations by easing worker mobility, together with active support to the manning of key positions by 'outsiders' in the public service, judiciary, and the disciplinary forces would be tangible support to small states in their pursuit of good governance that is considered critical for rapid development. Similarly, funding of research on lessons for development from the experiences of individual members and wide dissemination of such information will assist in the design of policies conducive to growth. The Commonwealth can also provide independent audits of the state of governance and economic policies within the family of member countries so as to provide information to the public to facilitate domestic and foreign direct investment.

In this vein, the Commonwealth could upgrade its annual publication, *Small States: Economic Review and Basic Statistics,* to assist international investors in choosing investment locations while providing policy makers direct feedback on the success of their policies. Additionally, the Commonwealth Trade and Investment Access Facility—an initiative of the Heads of Government at their 1997 meeting through joint funding by Australia, Canada, New Zealand, and the United Kingdom—could be revamped[4] to help small states take maximum advantage of the opportunities presented by the

[4] The Commonwealth Private Investment Initiative (CPII) could similarly be revamped to facilitate private capital flows.

increasing flows of world trade and investment. Within the same spirit, the Commonwealth should continue its assistance to states in addressing global issues of international tax evasion, drug trafficking, and money laundering.

The Commonwealth has a role in the last mentioned particularly in promoting market access for its small states. Furthermore, the Commonwealth can take advantage of its wealth of skills and experience to reduce the adverse effects, particularly on arms-length governance, of kinship ties in small communities—what Harberger (1988) calls "the tyranny of demography".

5. Conclusion

Small economies face several constraints to development, many of which are similar to those faced by larger economies. This chapter has provided a brief survey of the problems peculiar to small states due to their limited resources and openness to international trade. It is argued that smallness, openness, and isolation are interrelated since a small state often exists because it is isolated. Furthermore, these realities limit the ability of a state to diversify its production base, making it highly dependent on international trade.

The realities of the global capital market force small open economies to adopt fixed exchange rates; this in turn limits their ability to use stabilisation policy to reduce the amplitude of business cycles. These factors combined mean that small states are prone to volatile domestically sourced income, a reality that small states have to live with and be prepared for. The international factor markets can provide the opportunity to diversify income sources away from the local economy—thus access to such opportunity is more important for small economies than it is for larger ones.

Smallness confers specific problems in respect of development, but these problems are surmountable. For example, the lack of economies of scale can be minimised by deeper integration with the global market; the debilitating effects of isolation are falling with declining communications costs as telecommunications technology improves; and exposure to volatile production and earnings can be reduced via use of financial instruments. In short, the adversities of smallness can be overcome by well-targeted policy.

A major constraint relates to the fact that many small states lack the capacity for good governance and economic management, partly due to the small pool of skills at their disposal and also due to the inevitability of forming "kinships" in small communities. The wider international community and the Commonwealth in particular can make a contribution on this front by making available skills and personnel to overcome this handicap peculiar to small states.

Finally, contrary to Easterly and Kraay (2000) who suggest that small states have small problems, we argue that small states have big problems but the incentives for them to overcome these problems are even bigger! Consequently, those states that manage to overcome the handicaps of smallness do indeed perform better in terms of economic development than the rest.

Small states therefore can least afford poor economic management. But the argument that since some small states have done well they have small problems is flawed; the successes deserve closer scrutiny so that they can be replicated elsewhere.

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