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MACROECONOMIC REFORM AND RESILIENCE BUILDING IN SMALL STATES

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Abstract. Sound macroeconomic policies are key requirements for building economic resilience in small states to enable them to withstand the impacts of exogenous shocks, including weather-related disturbances. The capacity to forge ahead in the midst of adverse circumstances through various measures for promoting and sustaining a higher degree of self-reliance in small states, often undergoes serious setbacks due to frequent policy slippages, which exacerbate domestic and external imbalances. This chapter reviews the requisites for sound macroeconomic policies and refers to steps taken by governments of small states in recent years to nurture economic resilience.

1. Introduction

Volatility in income and consumption of small states tends to be relatively high when compared to other countries (Kose and Prasad, 2002), possibly because of their relatively high exposure to external shocks. In addition, the unique economic and geographical characteristics of many small states impose serious constraints, which limit their ability to cope with exogenous shocks be they anticipated or unanticipated. In these circumstances, the building of economic resilience is of utmost importance. The capacity to bounce back from or withstand the impacts of exogenous shocks, and forge ahead, requires deliberate measures over a period of time to implement and sustain sensible economic policies.

In the growing literature on small states and their vulnerability, the so-called "Singapore Paradox" has been cited as an example for consideration (see Briguglio, 2004). However, the Singapore model is not easily replicable. Singapore is known for its high commitment to economic growth and development, strong sense of discipline in all walks of life, together with a unique political structure—which in the past restricted some personal freedoms, although considerably relaxed in recent years—along with legal institutions to swiftly prosecute and punish both regular and white collar criminals. But, there are other small states that have been successful in nurturing economic resilience through measures and policies which could be more easily emulated than is the case with the Singapore model. The success of building resilience in a small economy will, however, depend on macroeconomic stability as policy slippages in this regard could lead to domestic and external imbalances.

This chapter deals with aspects of macroeconomic policies in small states which may be conducive to stability and which, therefore, nurture economic resilience. The chapter is organised into four sections. Following this introduction, section 2 outlines the ingredients of economic resilience and explains how they are closely linked with macroeconomic stability and reviews diverse experiences of small states in four regions: the Caribbean, the Indian Ocean, the Mediterranean and the Pacific. Section 3 puts forward a number of policy prescriptions for economic resilience building, while section four presents a summary and conclusions.

2. Ingredients of Economic Resilience

Many Small Island Developing States (SIDS) suffer from various handicaps mostly due to their geographical locations and their small economic size. Many SIDS are located far away from the main centres of economic activity, and as a result, transport costs render their imports and exports relatively more expensive. In addition, the location of many SIDS exposes them to frequent natural disasters.

The small economic size of SIDS leads to a number of constraints, including limited ability to reap the benefits of economies of scale. Small economic size is also associated with a high degree of economic openness. The openness to trade of small states, as measured by the ratio of imports and exports to gross domestic product, render their economies prone to shocks of all kinds. This is exacerbated by their narrow range of exported products and their high dependence on export earnings to pay for strategic imports. Furthermore, the small size of their domestic markets limits possibilities for import substitution (Briguglio, 2004).

Despite these handicaps, many small states have managed to forge ahead economically, mainly because of strong trade links with the countries that were formerly their colonial masters. Some small states such as Cyprus and Malta have, through far-reaching reforms, reduced their dependence on donor countries and achieved their ambitious goals of accession into the European Union (EU). Conversely, other small states continue to strongly depend on external aid. Overseas development assistance (ODA) for budgetary purposes, as well as projects and programmes, mostly in terms of grants and in some cases loans at very low interest rates with long maturity, have been providing considerable support to such states over last three decades. However, such aid has recently been dwindling in relative terms, as shown in Table 1. Since the end of the cold war, the priorities and directions of ODA have dramatically changed, resulting in some variability in this assistance. The future of small states that depend heavily on ODA therefore, seems uncertain (Chand, 2003b).

In addition, the economies of many small states have, in the past, been sustained by preferential trading arrangements by the EU and the United States, permitting many small states to sell their primary products, mostly sugar and banana, at a price higher than the prevailing world prices for these products. The advent of the new regime under the World Trade Organisation and the consequent phased dismantling of preferential treatment for imports from small states, such as sugar in the case of Belize, Mauritius, St Kitts and Nevis, Guyana, and Fiji and banana in the case of St Lucia, and in some cases, the abrupt discontinuance of quotas, as in the case of Fiji's garment exports to the US, have cast a shadow of gloom.

Many small states are now forced to gear up to the new challenges of having to restructure their economies, due to the difficulties of competing with larger countries in the export of primary products.

Macroeconomic Volatility

While the limitations imposed by the small size of domestic markets are well understood, macroeconomic volatility needs to be discussed in some detail. Small states tend to experience much higher variability in output than larger territories (see Table 2)—a consequence of their relatively high degree of economic openness, as well as of natural phenomena, including floods, cyclones, earthquakes and pest invasions. In recent years in some of the Pacific island countries (PICs), man-made disasters, such as coups and ethnic conflicts have also disrupted economic activities (Chand, 2002b).

Volatility in the terms of trade is also of major concern for small states. This is especially so in the case of primary commodity producing countries specialising in sugar, copra, banana, coffee and cocoa. Kose and Prasad (2002) have shown that the variability in the terms of trade of small states is nearly four times higher than that of the industrialised countries (Table 3).

Table 1
Selected Key Indicators

	Population ('000)	Per Capita GDP in US$	Human Dev Index Ranking	Aid per capita US$	Aid per capita % of GDP 1990	Aid per capita % of GDP 2002
Caribbean Region						
Antigua and Barbuda	76	10,449	55	192.1	1.20	1.90
Bahamas	314	15,797	51	-	-	-
Barbados	270	9,423	29	12.8	0.20	0.10
Belize	256	3,382	99	88.6	7.60	2.60
Dominica	79	3,438	95	381.7	11.90	12.10
Dominican Republic	8,745	2,514	98	18.2	1.40	0.70
Grenada	80	4,060	93	117.5	6.30	2.30
Guyana	765	937	104	84.9	42.60	9.00
Haiti	8,132	415	153	8.9	5.90	4.50
Jamaica	2,651	3,008	79	9.2	5.90	0.30
St Kitts and Nevis	42	7,745	39	683.8	5.10	8.00
St Lucia	1,419	4,124	71	226.5	3.10	5.10
St Vincent/Grenadines	120	4,060	87	40.1	7.80	1.30
Suriname	436	2,199	67	26.9	15.50	1.20
Trinidad and Tobago	1,303	7,384	54	5.6	0.40	0.10
Indian Ocean						
Maldives	280	2,182	84	88.9	9.80	4.40
Mauritius	1,211	3,740	64	19.8	3.70	0.50
Seychelles	82	8,320	35	97.8	9.80	1.10
The Mediterranean						
Cyprus	765	13,210	30	64.8	0.68	0.65
Malta	397	9,733	31	28.44	0.22	0.29
The Pacific						
Cook Islands	19	2,651	62	490.9	-	28.00
Fiji	799	2,281	81	41.0		1.80
Fed. States of Micronesia	114	1,864	120	702.0	-	37.40
Kiribati	85	530	129	203.3	-	18.60
Marshall Islands	51	2,008	121	823.3	-	49.60
Papua New Guinea	5,099	523	133	36.4	12.80	7.20
Samoa	175	1,484	117	214.2	42.60	14.50
Solomon Islands	418	541	124	56.8	21.70	11.00
Tonga	98	1,347	63	217.2	26.30	16.40
Tuvalu	11	345	118	260.0	472.7	45.0
Vanuatu	183	1,138	129	133.0	33.0	11.7

Notes:
1. Population and per capita GDP figures for the Caribbean are for 2003
2. Population and per capita GDP figures for the Indian Ocean and the Pacific regions are for 2001
3. Human Development Index for 2002

Source: ADB (2004), IMF (2004b), UNESCAP (2004)

Table 2
Output Growth and Variability

	1990-2003 Average Growth (%)	1990-2003 SD	1990-1997 Average Growth (%)	1990-1997 SD	1998-2003 Average Growth (%)	1998-2003 SD
Caribbean Region						
Antigua and Barbuda	3.2	3.0	3.0	3.6	3.3	0.8
Bahamas	0.4	3.8	0.9	3.5	2.2	1.4
Barbados	0.4	3.6	0.1	4.1	1.4	2.8
Belize	6.7	4.3	5.7	4.1	7.2	4.6
Dominica	1.4	2.3	2.7	1.4	0.5	3.1
Dominican Republic	4.7	4.0	3.9	4.6	5.0	2.2
Grenada	3.6	3.0	2.8	2.7	3.9	1.8
Guyana	3.3	5.2	5.9	4.1	0.5	3.2
Haiti	-0.4	5.4	-0.4	6.5	0.6	1.7
Jamaica	1.0	2.0	0.2	2.4	1.0	0.9
St Kitts and Nevis	3.7	2.1	4.5	2.3	2.3	1.1
St Lucia	1.7	3.2	2.7	2.4	0.8	4.8
St Vincent/Grenadines	3.2	2.5	3.3	3.0	2.7	1.7
Suriname	2.1	5.3	0.7	6.2	2.4	1.7
Trinidad and Tobago	2.9	2.6	2.0	2.3	4.2	1.6
Indian Ocean						
Maldives	7.7	3.1	8.4	3.6	6.7	2.3
Mauritius	4.6	2.2	4.7	2.4	4.4	2.0
Seychelles	3.6	2.9	4.0	3.3	2.7	2.1
The Mediterranean						
Cyprus	4.2	2.6	4.3	3.3	4.1	1.3
Malta	4.4	2.2	5.3	0.9	2.8	2.8
The Pacific						
Cook Islands	3.3	4.2	2.7	4.6	3.5	5.3
Fiji	1.6	3.7	2.6	2.4	2.7	4.2
Fed. States of Micronesia	1.8	4.0	2.3	5.1	0.2	4.6
Kiribati	2.9	5.8	3.0	2.8	5.0	4.5
Papua New Guinea	3.2	6.2	5.6	8.4	-0.2	3.9
Marshall Islands.	2.3	7.9	-0.9	7.7	0.3	4.6
Samoa	0.5	7.6	-8.1	11.2	3.9	2.1
Solomon Islands	0.1	5.6	2.9	3.8	-3.7	6.0
Tonga	2.5	2.8	3.3	3.5	2.3	2.1
Tuvalu	3.8	5.4	5.6	6.2	4.8	4.5
Vanuatu	2.1	3.7	4.4	4.0	0.8	3.4

Source: Author's Calculations, IMF (2004b), ADB (2004), UNESCAP (2004)

Table 3
Volatility: Standard Deviations of Annual Growth Rates (1960-2000)

Category of Countries	Terms of Trade	Private Consumption	Private/Public Consumption	Output
Small States	5.6	12.6	7.7	5.8
Other Developing Countries	4.2	8.2	8.7	4.9
Industrialised Countries	1.5	2.6	2.2	2.5

Source: Kose and Prasad (2002)

Economic Resilience and Macroeconomic Conditions

Economic resilience has been defined as the ability of an economy to bounce back or recover following an adverse external shock (Briguglio, 2004). Sound macroeconomic policy, leading to improved macroeconomic stability, is therefore a major prerequisite for resilience-building.

Macroeconomic policy is multifaceted, with the most important facet being fiscal policy, since this in turn affects prices, interest rates and the exchange rate of the domestic currency, with repercussions on the current account of the balance of payments. An unsustainable fiscal position, often resulting in persistent government deficits, financed by domestic borrowing, tends to push up interest rates and reduce the stock of loanable funds available to the private sector. Often, central banks of small states, in the absence of sufficient autonomy, tend to succumb to pressures from the treasury and fail to say "no" to fiscal abuse (Fry, 1993). Monetisation of fiscal deficits on a regular basis has been a major cause of crowding out of the private sector. In the subsequent bidding up process for resources by the dominant public sector, price level rises.

Fiscal Balance

Table 4 presents indicators in terms of overall fiscal balance, defined as the difference between total revenue including grants, and total expenditure including interest payments, for two periods, namely 1990-97 and 1998-2003. The table also gives data on inflation and rates of growth. In the Caribbean region, the ratios of overall fiscal balance to GDP of the 15 states were mostly negative during 1990-1997 and 1998-2003 and the magnitudes of deficits have invariably widened during 1998-2003 as compared to 1990-1997. On the other hand, all the Caribbean small states have done better on the inflation front.

The reason for lower inflation levels may have been due to the worldwide decline in prices of essential commodities in industrialised countries in 1998-2003. One notable result is that the states, which experienced lower levels of inflation during 1998-2003, have done better in terms of output growth. For example, Belize, which had the lowest average inflation at less than one percent (0.8 percent) during 1998-2003, recorded the average highest growth rate of 7.2 percent during the corresponding period.

The fiscal deficits of the Indian Ocean SIDS have been relatively small with mixed performance. While Seychelles reduced its fiscal deficit over the period, Maldives' fiscal deficit increased in 1998-2003. Mauritius and Seychelles have experienced relatively high inflation rates in 1998-2003.

Table 4
Macroeconomic Indicators

	Exchange Rate Regime	Fiscal Balance (% of GDP)		Inflation (%)		Growth Rate (%)	
		90-97	98-03	90-97	98-03	90-97	98-03
Caribbean Region							
Antigua and Barbuda	CB	-5.2	-7.9	3.7	1.8	3.0	3.3
Bahamas	FP	-1.7	-1.8	3.2	1.9	0.9	2.2
Barbados	FP	-2.8	-5.0	-3.5	1.0	0.1	1.4
Belize	FP	-5.6	-10.9	2.9	0.8	5.7	7.2
Dominica	CB	-3.4	-8.2	2.6	-0.3	2.7	0.5
Dominican Republic	IF	-2.5	-3.2	17.7	10.1	3.9	5.0
Grenada	CB	-3.9	-7.1	2.6	2.1	2.8	3.9
Guyana	MF	-3.6	-5.9	30.1	5.3	5.9	0.5
Haiti	MF	-4.4	-3.8	23.2	15.0	-0.4	0.6
Jamaica	MF	0.2	-8.5	32.6	7.3	0.2	1.0
St Kitts and Nevis	CB	-1.7	-11.2	3.5	2.5	4.5	2.3
St Lucia	CB	-1.0	-2.5	3.1	2.1	2.7	0.8
St Vincent/Grenadines	CB	-0.6	-3.5	3.6	0.9	3.3	2.7
Suriname	FP	-3.7	-6.3	105.7	43.1	0.7	2.4
Trinidad and Tobago	MF	0.2	-2.2	6.3	3.3	2.0	4.2
Indian Ocean							
Maldives	FP	-6.7	-4.3	8.5	0.2	8.4	6.7
Mauritius	MF	-0.1	-1.4	7.2	5.6	4.7	4.4
Seychelles	FP	-7.9	-1.7	1.4	5.3	4	2.7
The Mediterranean							
Cyprus	FP	-3.8	-3.4	4.4	2.1	4.3	3.8
Malta	FP	-5.0	-7.1	2.7	2.4	5.3	2.4
The Pacific							
Cook Islands	DL	-4.0	-1.4	2.7	3.5	3.0	3.5
Fiji	FP	-3.2	-3.4	2.6	2.7	4.3	2.7
Fed States of Micronesia	DL	-15.9	-7.8	2.3	0.2	3.3	0.2
Kiribati	DL	6.8	4.2	3.0	5.0	4.2	5.0
Papua New Guinea	IF	-2.7	-2.1	5.6	-0.2	7.4	-0.2
Marshall Islands	DL	-20.3	11.1	-0.9	-0.3	6.0	0.3
Samoa	FP	-2.8	-0.6	-3.1	3.9	5.7	3.9
Solomon Islands	FP	-5.1	-3.6	2.9	3.7	10.8	-3.7
Tonga	FP	0.1	-1.0	3.3	2.3	4.6	2.3
Tuvalu	DL	-6.1	18.0	5.6	4.8	2.9	4.8
Vanuatu	FP	-4.0	-1.8	4.4	0.8	3.4	0.8

Source: IMF (2004b), ADB (2004), Sahay (2004), UNESCAP (2004)

Legend for Exchange Rate Regimes

CB = Currency Board
DL = Dollarised
FP = Fixed Peg
IF = Independent Float
MF = Managed Float

However, on the output front, all the three aforementioned states have continued their good record of growth. In the Mediterranean, the two small states of Cyprus and Malta, the size of fiscal deficits was in the range of 4 percent to 5 percent in 1990-97. During the period 1998-2005, the fiscal deficit of Cyprus declined slightly, while that of Malta increased.

Generous external aid to PICs has often provided cushioning support to their budgets as well as to the current account balances. However, ODA has also been causing problems of its own, since it may have given rise to an appreciation of the real exchange rate via increasing prices, adversely affecting export oriented activities, including tourism (Jayaraman, 1996). Another impact of steady aid inflows may have been the reduced effort on the part of the government to increase their own revenues.

Empirical evidence gathered by a recent study (IMF, 2004a) confirms that the benefits of external aid tends to be totally offset by a reduced tax effort. In addition, as part of an increasingly evident phenomenon of global corruption, small states being no longer an exception, unethical behaviour of elected leaders, politicians and the bureaucracy and declining standards in good governance have resulted in abuse of aid funds (Hughes, 2003; Chand, 2001).

In recent years, there have been fewer occurrences of monetisation of fiscal deficits by central banks (Rosales, 2001), as governments increasingly resort to public borrowing for financing their fiscal deficits. In small states which have excess liquidity in the system, domestic borrowing was not difficult. Fiji, for example, stepped up public borrowing to finance its deficits during three consecutive years, with the lender being the National Provident Fund.

The fiscal expansion in many small states has been causing concern regarding the rise in public debt. In some PICs, thanks to generous ODA, public debt level has been low (Table 5). However, in Fiji, which receives grants of only about 4 percent of GDP, public debt has been increasing.

In 2003, Fiji's public debt, including contingent liabilities, was slightly higher than 60 percent of GDP, higher than the international benchmark of 40 percent of GDP (Narube, 2004). While domestic debt in other PICs is low, external debt has been rising. Most of the external debt to PICs is on concessional terms, as the loans are from multilateral agencies. Debt service as percent of total exports of goods and services does not exceed 7 percent. The external debt of Fiji, which is not eligible for concessional loans from the multilateral agencies including Asian Development Bank, was 11 percent of GDP and the debt service ratio around 6 percent in 2003.

Table 5
Debt Levels (% of GDP)

	Total Debt	External Debt	Domestic Debt
*Caribbean Region***			
Antigua and Barbuda	114.3	-	-
Bahamas	48.0	45.0	2.0
Barbados	84.0	25.9	50.1
Belize	93.2	-	-
Dominica	122.0	94.9	27.1
Dominican Republic	56.0	25.2	31.4
Grenada	109.0	90.3	18.7
Guyana	179.0	-	-
Haiti	44.0	36.2	7.8
Jamaica	142.0	75.3	66.7
St Kitts and Nevis	159.7	82.8	76.9
St Lucia	66.0	-	-
St Vincent and the Grenadines	71.0	60.1	10.9
Suriname	44.0	-	-
Trinidad and Tobago	54.0	29.1	24.3
*Indian Ocean**			
Maldives	61.0	42.0	19.0
Mauritius	54.5	5.8	48.7
Seychelles	-	-	-
*The Mediterranean***			
Cyprus	58.0	14.5	43.5
Malta	55.9	3.4	52.5
*The Pacific**			
Cook Islands	-	55.6	-
Fiji	58.4	11.4	47.0
Fed States of Micronesia.	-	25.0	-
Kiribati	-	4.0	-
Papua New Guinea	74.0	-	-
Republic of Marshall Islands.	-	-	-
Samoa	-	90.2	-
Solomon Islands	92.5	66.1	26.4
Tonga	-	54.3	-
Tuvalu	-	33.4	-
Vanuatu	-	36.2	-

* relates to data for 2002
** the most recent year for which data are reported

Sources: Sahay (2004); World Bank (2004) and IMF (2005a) for Caribbean Countries; ADB (2004) for Pacific Countries; IMF (2005b) for Cyprus and Malta

In the Caribbean mounting public debt is also a source of major concern (Wint, 2004). In 2004, it stood at 179 percent of GDP in Guyana, 160 percent in St Kitts and Nevis, 142 percent in Jamaica, and 122 percent in Dominica and 114 percent in Antigua and Barbuda (Table 5). The concern arises, amongst other things, because of the growing annual interest burden it imposes on the government. Interest payments have to be effected out of the primary balance, defined as surplus of current revenues over current expenditure, excluding interest payments. A study by Sahay (2004) shows that during 1991-2002, the highly indebted countries in the Caribbean, except Jamaica, failed to generate primary surpluses. The result was a further deterioration in their overall fiscal balances, leading to rise in debt levels, as interest payments have to be financed by recourse to additional public borrowing.

The focus, therefore, shifts onto the primary balance. Improvement in primary balance can arise either from increases in current tax rates or the imposition of additional taxes or reduction in current expenditure. The latter would always be easier and the axe usually falls on expenditures on maintenance of current assets, including roads and ports, and hospital and schools. Additional effort is therefore needed to step up revenue collection. Selowsky (2004) underscores the need for greater efforts to reduce evasion of customs, income and company taxes from well known tax payers, particularly if they are powerful. If no additional tax effort is made, either in terms of rises in existing tax rates or the imposition of new taxes, if present slackness in revenue collection continues, and if the tax machinery is subject to political influence and corruption, only growth in output could improve the economic situation, since tax revenue tends to be income elastic.

Fiscal Deficits and the External Sector in Small Economies

In open economies, fiscal deficits often lead to external current account deficits, thus giving rise to the emergence of twin deficits, as imports dominate both public and private consumption (Jayaraman, 1993). Furthermore, under a fixed exchange rate regime, which is adopted by many small states, in the absence of downward flexibility in prices and wages, a rise in the domestic price level relative to foreign prices, leads to the appreciation of the real exchange rate, causing an additional problem in the external sector. The nominal exchange rate further exacerbates the situation by encouraging imports, contributing to the worsening of current account deficits. A study on fiscal imbalances and real exchange rate movements during 1979-1992 (Jayaraman, 1997), shows that in Fiji—which has adopted a fixed exchange rate regime—expansionary fiscal policies adopted by the government led to a rise in the real exchange rate. The transmission of influence was through excess demand by the public sector for non-tradable goods, resulting in increases in domestic price level relative to foreign prices.

Changes in the real effective exchange rates (REER) of a number of small states are shown in Table 6. The swings in REERs are closely related to domestic price movements, which are caused by supply factors, arising from natural factors as well as due to fiscal imbalances and the manner of their financing. It should also be noted that corrections in nominal exchange rates also contributed to changes in REERs. For example, Fiji, Solomon Islands and Papua New Guinea devalued their currencies in 1998 soon after the 1997 financial and currency crises in East and Southeast Asia.

It may be argued that current account deficits are not necessarily worrisome (Intal Jr, 1991). It is the nature of financing of such deficits that would raise the question as to whether such deficits are ultimately sustainable or otherwise. There are three ways of financing current account deficits: external borrowing, running down international reserves and inflows of portfolio and direct investment. International experience has shown that financing the current account deficits through inflows of capital is the most suitable way. On the other hand, the other two forms of financing, namely, drawing down the reserve and external borrowing, do not make the current account deficits sustainable.

Table 6
Change in Real Exchange Rates (%)

Year	Antigua/ Barbuda	Bahamas	Dominica	Dominican Republic	Grenada	Guyana	St Kitts/ Nevis	St Lucia	St Vincent/ Grenadines	Trinidad & Tobago	Fiji	Papua New Guinea	Solomon Islands
1992	-1.3	2.6	0.8	1.2	-0.9	9.0	-1.3	0.7	-1.5	2.2	0.5	0.1	-1.1
1993	5.8	2.3	2.8	3.7	5.5	8.4	2.8	3.8	6.9	-9.7	3.7	4.6	0.9
1994	-8.0	-4.0	-3.5	4.3	0.0	-0.8	-0.8	-1.0	-2.8	-6.8	-0.6	-5.5	3.2
1995	-3.6	-3.4	-5.8	2.9	-3.4	1.8	-2.4	-1.3	-4.8	-2.3	-1.9	-15.0	-2.3
1996	1.6	8.5	1.4	2.3	1.2	7.3	0.8	1.3	4.2	1.9	1.8	7.6	6.8
1997	1.2	-5.3	5.3	4.9	2.6	5.1	-0.2	2.2	3.5	0.4	4.9	0.6	8.6
1998	2.2	1.9	12.4	-0.7	1.1	0.6	11.8	3.1	3.6	5.0	-16.9	-14.7	-6.4
1999	0.4	2.8	-7.5	-0.9	0.8	-10.4	2.2	3.1	-0.4	2.6	0.2	-8.7	2.9
2000	2.1	2.6	1.9	4.3	3.7	5.2	2.3	5.6	2.7	4.6	-1.6	10.0	6.0
2001	3.5	2.4	3.8	-	3.8	0.9	1.1	0.4	2.1	7.6	0.2	-6.4	9.2
2002	-0.5	0.1	-2.6	-	-0.9	-	-0.5	-	-2.8	2.0	0.1	-6.5	-16.9
Mean	0.3	1.0	0.8	2.4	1.2	2.7	1.4	1.8	0.7	1.0	-0.5	-2.5	1.1
SD	3.7	3.9	5.6	2.1	2.5	5.8	3.8	2.2	5.1	3.6	5.6	8.2	7.3

Source: IMF (2004b)

Further, mounting fiscal and current account deficits and decreasing international reserves with rising price levels are more likely to lower the credibility of the borrowing government in the eyes of international creditors. Ability to borrow externally drastically declines, as the domestic fiscal position deteriorates. In the absence of any massive financial support to maintain the exchange rate, devaluation could be the final remedy.

For devaluation to work, supporting measures, including price stability and expenditure reduction are necessary. Most of the reduction in expenditure has to be borne by the public sector, in view of its predominance in the economy, and as the biggest employer in a small economy's formal sector.

Exogenous Shocks and Fiscal Flexibility

Fiscal discipline permits a degree of fiscal flexibility and encourages lower interest rates, which would not crowd out private investment. It also minimises debt build up, which will eventually allow for counter-cyclical spending to protect the poor in adverse times (Birdsall, 2004). Reforms in the medium term, which foster fiscal discipline, focus on fiscal consolidation objectives: reduction in discretionary public expenditures such as public employment, transfers, public consumption of goods and services, investment and other capital spending.

Exogenous shocks, which are often the major cause of economic volatility in small island states, however have various negative effects, including the endangering of fiscal reform programmes (Khamfula, 2005). There is the danger that fiscal consolidation objectives are sacrificed in the immediate after-impact of a major external economic shock, including those arising from a natural disaster or a supply shock such as an oil price hike. Setbacks to the fiscal reform process therefore adversely affect resilience building efforts, including the gradual process of financial sector liberalisation to participate effectively in the globalisation process as well as towards diversification of economic activities.

The Financial Sector

An important development in many small states relates to the financial sector. In the past, some small states, with low or no direct taxes at all on personal or company incomes encouraged offshore financial centre (OFC) activities (Jayaraman, 1998). These OFCs, known as tax havens, unfortunately fell into disrepute, due to what were considered as harmful practices and illegal activities by the OECD countries. A deliberate attempt to "name and shame" small tax haven islands ensued (Persaud, 2000). Since the 9/11 event of 2001, the OFCs came under greater scrutiny for likely money laundering and possible links to terrorist activities. Aware of the unsolicited adverse publicity, some of the islands with OFCs have been trying to change their image, in order to attract legitimate capital inflows.

Briguglio (2001) lists the difficulties involved in financial sector development. Aside from the shortage of specialised skills, the small states have to embark on a process of liberalisation under conditions of existing market imperfections, sluggish adjustment and bank supervisory realities in the country. Financial markets are thin and shallow with very few securities, mostly dominated by government bonds and treasury bills. Furthermore, the players are very few: two to three foreign owned banks and a few government owned enterprises and the national provident funds, which have heavily invested in them. These realities are likely to adversely affect the country's resilience in the face of external shocks. Although interest rates in many small states have been freed from government controls and other restrictions on financial sector institutions such as the government-directed lending for priority sectors have been discontinued, interest rates have not really come down (Jayaraman and Sharma, 2003; Chand, 2002a).

In small states, there tends to be a relatively large spread between lending and deposit rates, a reality reflecting the market imperfections. These imperfections have been observed to inhibit investment in the private sector, which in way adversely affects resilience building. Available studies (see, for example, Asian Development Bank, 2001) ruled out the presence of oligarchic conditions due to small number of banks as a cause behind high interest spread. The high interest rate spread appears to result from a combination of factors, including (i) regulations such as minimum liquid assets that are kept high so as to force commercial banks to buy government securities; (ii) lack of economies of scale in banking operations; (iii) lack of collateral; and (iv) poor enforceability of debt contracts. In addition, there is the problem of time inconsistencies, since policies pursued by government were not subject to binding commitments and were changing from time to time. Again, these factors tend to adversely affect the country's resilience in the face of external shocks.

Regional Integration

Regional integration can help small states become more economically resilient (Chand, 2003a; Jayaraman, 2004a). Integration arrangements may include a regional common currency by adopting the currency of a developed country with a proven record of low inflation and high growth and employment. Under the "currency board" arrangement the national currencies would continue to exist but the monetary authorities would be required to hold foreign currency reserves to at least cover the entire narrow money supply (Enoch and Gulde, 1997), and would be ready to exchange domestic currency for foreign currency at the fixed rate on request. This arrangement would involve additional restrictions on central banks, as these would not be able to pursue independent exchange rate policies or react to a negative terms of trade shock by devaluing the domestic currency. It will also restrict governments from monetising fiscal deficits (Jayaraman, 2001).

Gains from monetary union in any form are important from other angles as well. It can lead to (a) a credible mechanism for defending a fixed exchange rate; (b) macroeconomic stability; (c) confidence in the monetary system; and (d) greater incentives for inflows of foreign direct investment (FDI), thereby promoting trade, investment and growth. A recent study on monetary policy implementation in small countries (IMF, 2005b) refers to gains from common currency. The latter are in terms of fostering fiscal discipline, such as through fiscal convergence benchmarks. Another gain is that a common central bank would be in a better position of strengthen human and technical resources in order to develop institutional capacity for advising the member governments' fiscal authorities and for coordinating fiscal and monetary policy. Furthermore, this would also facilitate money market development by making it possible for markets of small countries, which are normally too small and too limited for successful open market operations in central bank paper, to reach the critical size.

In the case of the Caribbean small states there is a degree of monetary union by Organisation of Eastern Caribbean States (OECS), by establishing a common currency board under Eastern Caribbean Currency Union, with its Eastern Caribbean dollar linked to the US dollar at the fixed rate since the late 1970s. The goal for a CARICOM's common regional currency is however still far off. Courtney Blackman (1998), the founding father of the Central Bank of Barbados, who spearheaded a campaign for a Caribbean monetary union, emphasised the role of politics as the most critical factor. The situation in the Pacific is no different. The current Secretary-General of the Pacific Forum recently described the commitment to regionalism as patchy (Urwin, 2004).

3. Policy Prescriptions

The policy prescriptions discussed below relate to eight areas which are considered to be the most important for resilience building in small states, since they contribute towards reducing economic instability:

- fiscal consolidation;
- financial liberalisation;
- promotion of domestic competition;
- promotion of international competitiveness;
- effective utilisation of aid;
- reducing wastage and inefficiencies, and preventing corruption;
- encouraging FDI; and
- strengthening disaster management.

Fiscal Consolidation

The role of monetary policy in small, open economies under fixed exchange rate regimes is generally found to be limited. In the past, existence of exchange controls had enabled monetary policy to be of some use (Khatkate and Short, 1980). With increased liberalisation and dismantling of exchange controls especially in regard to current account, monetary policy is not likely to play any effective role. Further, with nascent money and capital markets, transmission mechanism has been observed to be weak. As a result, there has been a growing reliance on fiscal policy as a tool for development.

However, because of fiscal excesses, macroeconomic situations in small states have become worrisome. Increasing debt levels have given rise to various concerns, as mounting interest payment burden eats into limited revenue, denying growth-creating investments in the public sector. Further, the limited private sector finds itself increasingly crowded out by the bloating public sector. Reforms have been initiated in almost all small states mostly at the insistence of international or bilateral funding agencies. However, experiences indicate that progress has been slow. At times, exogenous shocks often slow down the reform implementation processes, since urgent rehabilitation measures to meet emergencies lead to unbudgeted expenditures.

Fiscal consolidation reinforces credibility in the system. For example, discontinuance of subsidies and transfers and other discretionary items will send out positive signals to private investors, both domestic and overseas, that the government is serious about creating an enabling environment for private investment. Another step towards generating credibility in government policies relates to public sector reform. The bureaucracies in the ministries and departments have to be trimmed and inefficient public enterprises have to be closed. Commercial undertakings in the hands of the government have to be sold off to the private sector, while they are still commercially viable. Those, which are a drag on public finances and which cannot be sold, should be closed and any salvageable physical assets disposed of.

Simultaneously, tax effort has to be increased. Generous external grants have tended to create, in PICs in particular, a sense of complacency, resulting in lower revenue collection. In recent years, governance problems have also crept in. The growing corruption in tax machinery has to be tackled. Before thinking of new taxes or raising the existing tax rates, revenue collection effort has to be raised and malpractices and slackness should be checked and reduced by way of exemplary punishment of the officials involved.

In the context of a high level of public debt, a tight fiscal stance would be appropriate. Reductions in public spending should be accompanied by a change in the composition of public expenditure. Large cuts in unproductive spending, including those on surplus staff are likely to have good effects on growth. Further, in poorly governed small states, reducing the deficit helps improve factor productivity, because it forces government to use resources more efficiently and may also result in lowering inflation and stimulating investment.

Financial Liberalisation

Many small states have undertaken a process of liberalisation, particularly in the financial market. Villanueva and Mirakhor (1990) emphasise that macroeconomic stability and proper sequencing of reforms are essential ingredients for successful liberalisation. In the context of greater emphasis on macroeconomic stability, which is associated with low and sustainable fiscal deficits, low level of public debt and low inflation and stability in real exchange rates, there is an increasing recognition of the need for separating monetary policy implementation from fiscal expediency. This requires conferring full autonomy on central banks (Jayaraman, 2000), which would ensure credibility and transparency of government intentions in proceeding to the liberalisation of the financial sector.

Central banks should have full autonomy in resorting to increased use of indirect instruments, enabling the determination of short-term interest rates in the market place. Furthermore, if a pre-announced timetable of deregulatory steps is followed, there will be no time consistency problem, which has been afflicting the reform implementation in small states.

Although prudential regulations in small states have been strengthened in recent years in accordance with international standards, inadequate bank supervision in some PICs especially over the nationally owned banks resulted in their bankruptcies or near bankruptcies. These failures have done much damage to the economy (Chandra et al., 2004). Beside from adversely affecting the confidence in the banking system, bankruptcies resulted in huge budget deficits, which had to be incurred for bailing out the failed banks and for their subsequent restructuring. Failure to prevent financial scams as a result of weak prosecuting skills and inadequate legal machinery resulted in acquittals of white-collar criminals, including politicians. These occurrences also exposed weaknesses in the general system of governance.

Sequencing of reforms has been a subject of much debate. After the debacle of the Asian financial crisis of 1997, it is now appreciated that the final stage in liberalisation, namely abolition of all exchange controls resulting in the opening up of the capital account in the balance of payments, cannot be rushed through. Premature opening of the capital account poses serious risks when financial regulation and supervision are inadequate. In the presence of weakly regulated banking systems and other distortions in domestic capital markets, there is every possibility of misallocation of capital inflows (Kose and Prasad, 2004).

An IMF study (2005a) on stabilisation and reforms in Latin America, which is also of relevance to small states, acknowledges that the economic crises which battered the region in recent years were partly due to premature opening of their markets to capital from abroad without strengthening financial regulation, leaving them over exposed during financial crises. It also urges countries to (i) strengthen the independence and transparency of their central banks; (ii) increase their openness to trade and compete with Asia; (iii) improve the rule of law and tackle corruption; and (iv) improve legal machinery (IMF, 2005a). It should be recognised that a small country with a fixed interest rate regime is likely to increase its vulnerability to a financial crisis when it opens its capital account, given a thin financial market and its narrow export base.

It should, however, be noted that liberalisation of the financial sector would remain incomplete without eventual removal of exchange controls and capital account liberalisation (Briguglio, 2001). With two-faced exchange control policy, trying to attract capital flows but stringent in relation to outflows, one cannot expect substantial capital inflows in a sustained manner. Full capital account liberalisation requires achieving balance of payments stability over time, which will ensure that sustainable current account deficits are eventually bridged by capital inflows. Capital account liberalisation thus signals the country's commitment to good economic policies. If a country with open capital account fails to follow sound fiscal policies resulting in unsustainable deficits, leading to inflationary financing through accumulation of sizeable debt, a perceived deterioration in policy environment would lead to both domestic and external investors suddenly pulling their funds out of the country. This provides strong incentives for policy-makers to adopt and maintain sound macroeconomic policies. Such policies ensure capital inflows for long-term investment by supplementing domestic savings and facilitating transfer of technology and management skills, which are in short supply in small states (Prasad et al., 2003).

Promotion of Domestic Competition

In a small sized economy limitations on domestic competition occur because often a small market does not support a large number of firms producing a similar product. This generates a tendency towards oligopolistic and monopolistic structures. In spite of the constraints (see Briguglio and Buttigieg, 2004), it is important that small states put in place competition law and policies so as to reduce abuse from dominant firms and to foster efficient use of resources.

There are many cases where monopolies or quasi-monopolies in small island states led to excessive pricing, and underutilisation of resources, to the detriment of consumers and the economy as a whole. The recent outcry by the public as well as educational institutions in the Pacific in general and in Fiji, in particular against high pricing of internet services, which was attributed to much hesitancy to modernise, led to the Pricing Commission finally to intervene and fix prices for internet services.

The delayed intervention, which was long overdue, only exposed the technical and administrative deficiencies in government agencies, including the pricing commission, to monitor, supervise and exercise regulatory controls over the operations of monopolies. Existence of asymmetry of information between the private sector natural monopoly and regulators in the government results in poor quality control and high pricing of services, adversely affecting the ordinary consumers.

Many governments are now realizing that allowing greater domestic competition could lead to improvement in international competitiveness. This is especially so in the field of telecommunications. However, response to remedy the situations has been very slow.

Promoting International Competitiveness

International competitiveness of the Caribbean and Pacific island states has declined in recent years as reflected in key indicators (World Bank, 2005b; Jayaraman, 2004b), which include growth rates in exports of goods and services, and real exchange rates. As already explained, weak macroeconomic fundamentals lead to appreciation of real exchange rates. Fiscal deficits raise inflation rates, thereby contributing to the unattractiveness of exports.

In PICs, distortions in factor markets of land and labour have been identified as serious hurdles to promote competitiveness of exports. While strong trade unionism combined with minimum wage legislations have been responsible for discouraging investment in labour intensive activities, land tenure problems have rendered land a non-marketable commodity. Both domestic and overseas investors are reluctant to invest in land based activities ranging from commercial agriculture for producing tropical fruits and vegetables for exports to the lucrative markets in Australia and New Zealand, to resorts and hotels and other tourism related activities. Institutional improvements are needed so that land tenure ceases to be a problem. Within the current sociocultural framework, which forbids foreigners from owning any land, the existing leasing procedures should be further liberalised and direct negotiations with appropriate legal aid from the state should be encouraged. If lease rents were allowed to be determined in the free market, rents would rise in response to demand thereby raising the incentives for land owning communities to release additional land for economic use. In addition, the state should ensure that legal contracts be honoured and enforced by judicial courts.

Distortions in the labour market also deserve major attention. The minimum wage legislation, where it exists, should be repealed and wages allowed to be determined by market forces, and reflect productivity. Ultimately, productivity can be increased only through education and acquisition of skills. In many small states, the key areas needing immediate attention are primary and secondary education, which have been neglected all along. Instead of the current thrust on tertiary education resulting in the supply of graduates in liberal arts and humanities, emphasis should be on vocational education that shifts investment from university education to vocational guidance schools.

The following policy actions to increase PICs' international competitiveness and productivity are recommended. These policies are also relevant to other small states.

Short-term measures include: (a) reduction in the growth of the public sector wage bill; (b) introducing quality-enhancing and cost-cutting measures in the public sector; (c) improving expenditure management of government ministries and departments; (d) eliminating the ministers discretionary powers of tax exemption and concession and cancellation of work permits, without observing due process of law and procedures; (e) enhancing transparency in enforcement of legislation and rules and regulations; (f) enforcing the already executed legal and contractual agreements; and (g) annulling/reforming the minimum wage laws and regulations.

Medium/long-term measures include: (a) increasing investment in primary and secondary education by improving teacher/student ratio, supplying curriculum materials and constructing buildings and dormitories; (b) regulating and supervising the private monopolies supplying public utility services; and (c) reducing the operating costs of monopolies in public sector and improving the coverage of basic services.

Effective Utilisation of Aid

There has been a very clear declining trend in aid flows to small states in general. In the Caribbean region, aid declined from an average 6 percent of GDP during 1990-97 to 3 percent during 1998-2002 (World Bank, 2005a; Briguglio et al., 2005). In PICs, though the declining trend was not so dramatic, it was apparent that the two major donors, namely Australia and New Zealand, were not keen to continue the pattern of aid inflows on the past lines of budgetary support. The bilateral donors joined forces with the multilateral agencies in channelling aid funds as well as concessional loans towards comprehensive reforms in policy areas (Australian Senate, 2003).

A critical report by Hughes (2003) on aid utilisation in some island countries in the Pacific, which were described subsequently in the media as "failing states or failed states", has given the bilateral providers of aid added ammunition to push the reform progress further in many fields. These include public sector restructuring, provision of judges and upgrading prosecution machinery, as well as police personnel for improving maintenance of law and order. Now that bilateral assistance in terms of budgetary support for wages and salaries has become a thing of the past, programme aid and project assistance have not themselves become effective, as aid utilisation has been ineffective because of delays in implementation, which include a slow pace in floating tenders and their finalisation and in the provision of counterpart funds and services, including project personnel.

The Pacific island authorities are now aware that better utilisation of aid with control over use of funds and accountability would be necessary to justify the legitimate transfer of real resources to the resource-hungry small states, ensuring further inflows of aid in the future. Various mechanisms are in now place, including close monitoring at all levels, including coordination at both recipient and the provider levels.

Cutting Down Wastage and Inefficiencies and Corruption

Improving governance in small island countries requires devising means and ways for minimising wastage of resources, both financial and human. Aside from provision of training facilities for the bureaucrats, both pre-entry and in-service, the governments in particular need to provide checks and balances to curtail corruption. These include strengthening accounting in the ministries and agencies and independent audit machinery. However, it has been observed that, due to inadequate human resources in accounting skills, progress has been slow in ensuring timely audit. Most of the government enterprises have been late in releasing and submitting annual reports to the legislature.

Increasing incidences of corruption and scams are too numerous in the recent years to document. Hughes (2003) listed some of them in her study. New administrative remedies, such as the Ombudsman and other institutional innovations, these have proved a failure since island countries in the region did not have enough political will to pursue, prosecute and punish the culprits. The case in point is the insolvency of the government owned National Bank of Fiji. After protracted investigations over a decade, the alleged criminals were let free on the grounds of lack of evidence. The failure to punish the culprits was blamed on the prosecuting machinery and the legal system. Now bilateral donors are strengthening legal systems by providing seconding judges and prosecutors. Recent episodes of early release of the culprits in the coup-related crimes in Fiji do not inspire much confidence in the system.

The PICs have, sooner or later, to recognise the need for reinforcing their legal systems if they are to restore confidence. There is no point in blaming the globalisation process for the spread of corruption and white collar scams to the shores of island countries. The authorities have to be aware of best practice in the rest of the world as well and adopt it as early as possible.

Encouraging FDI

In the context of declining foreign aid, inflows of FDI are rightly looked upon as a substitute to supplement the inadequate domestic savings to keep up the desired levels of investment in the economy. Investment climate, which governments are seeking to improve with a view to encouraging domestic investment or for attracting FDI, has the same essential ingredients. Stern (2002) defined it as " the policy, institutional and behavioural environment, both present and expected, that influences the returns, and risks associated with investment". It comprises three components: (i) political and macroeconomic stability; (ii) a sound regulatory framework and efficient supporting institutions for enforcing contractual obligations and existing laws governing investment; and (iii) an adequate physical and social infrastructure (World Bank, 2005a).

While FDI amounts to about 20 percent of gross fixed capital formation in the Caribbean, the corresponding ratio in the Pacific islands is less than 10 percent. The FDI has been shown to have contributed to growth in the Caribbean (Borenzstein et al., 1998) and in the Pacific (Jayaraman and Choong, 2005) through facilitating the transfer of technology, management practices and business culture.

A recent study (Jayaraman and Choong, 2005) on determinants of FDI in the Pacific focusing on Fiji identified the following factors for attracting and retaining FDI: rate of economic growth, market size, openness policy and real exchange rate. The study further confirmed that there is bi-directional causal linkage between FDI and economic growth.

Small island states would do well in implementing various identified reform measures for attracting FDI inflows by deregulating the financial sector, laying down an investment code, and putting in place a separate government agency for rapid processing of FDI proposals.

Strengthening Disaster Management

The economies of small states in the Caribbean region are frequently affected by natural disasters. The OECS countries happen to be the most vulnerable in the region, as they rank among the top 10 countries by number of disasters per land area and per population (Rasmussen, 2004). In the Pacific region, the hurricane-affected countries are the Cook Islands, Fiji, Samoa and Tonga, whereas Papua New Guinea is also subject to frequent volcanic eruptions and earth tremors. Such occurrences lead to the contraction of output, and to pressures on the balance of payments and on government budgets.

Measures conducive towards minimizing the risks and adverse consequences of natural disasters include improving preparedness to meet the dangers to lives and properties in the short run and in the long run to better manage the environment, as natural disasters inflict the severest penalties on poorly managed environments.

Most governments in the two regions are increasingly strengthening disaster management capabilities. In the Pacific region, Fiji with its relatively higher human resources endowments has been able to establish a central disaster management agency with regional centres for providing advance warnings and for evacuating the affected people before and after the occurrence of disasters and provision of relief measures. Increasingly the policy-makers are aware of the need for involving the non-government organisations, which have regional and district centres, in planning and execution of relief measures.

Long run measures obviously include avoidance of past mistakes in land-use planning such as location of human settlements and building tourist hotels and resorts on fragile ecosystems. Although many improvements and procedural requirements, such as the need for environmental impact assessments and zoning restrictions are prescribed, weak and poor overseeing and enforcement due to influence peddling and corruption are serious lapses, which need to be prevented.

4. Summary and Conclusions

This chapter has attempted to identify the main areas that require attention to promote stability and to promote resilience building in small states. The chapter also put forward a number of policy prescriptions towards this end. In the current globalisation process, the gains from putting in place macroeconomic reform are obvious. Successful integration with the rest of the world on a sustained basis requires sound economic fundamentals, which in turn require prudent macroeconomic policies, including sustainable fiscal as well as current account balances, low inflation rates, and stability in real exchange rates. This is especially so for small states, which tend to be inherently economically vulnerable to external shocks due to the high degree of openness and limited diversification possibilities.

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