Thinking big

How can small states hold their own in an increasingly globalized economy?

M. Ayhan Kose and Eswar S. Prasad

The term “small state” generally refers to sovereign countries with fewer than one and a half million people (see box). By this criterion, 45 developing countries (41 of the IMF’s 184 member countries) are small states. They range from “micro” states, such as Palau and St. Kitts and Nevis, each with fewer than 40,000 people, to Botswana, Gabon, The Gambia, Guinea-Bissau, Mauritius, and Trinidad and Tobago, with more than one million people each (see Table 1).

With a total of only about 20 million people, small states account for a small fraction of the world’s population and output, but their number is significant enough to make them an important group. What do the inexorable forces of globalization portend for the viability and prosperity of small states? How can they protect themselves from being buffeted by these forces? The IMF has increased its research activities related to small states with a view to developing policies better suited to their special needs.

Is bigger better?

Small states face many disadvantages, including

- Geography. Many are located far from the major trade centers, signifi-
cantly increasing the costs of their exports and imports. Others are highly susceptible to natural
Disasters, such as earthquakes and hurricanes, that
can affect the entire country and therefore have a
devastating effect on the economy.

- **Vulnerability.** Their openness to trade, highly specialized production and export structures, and
heavy reliance on export earnings make small states particularly vulnerable to external shocks.

- **Diseconomies in production.** Small domestic
markets make it difficult for these states to reap
benefits of scale. They also face diseconomies
because of having to produce public goods on a
small scale.

Notwithstanding the challenges associated with
their size, small states have been able to register, on
average, higher growth rates than other countries
thanks to their stronger trade links and higher
investment ratios. One additional possible advantage—and an interesting theoretical trade-off in
terms of public finance considerations—is that
small states typically have more homogeneous
populations, with similar preferences for public
goods. In principle, such homogeneity could enable more efficient targeting and provision of
public goods and foster greater social and eco-
nomic stability.

On balance, the optimal size of a sovereign
nation depends on a number of considerations, but
most of the challenges faced by small states are the
by-product of the relationship between economic
size and macroeconomic volatility.

**Size is key to volatility**
Small states have relatively high GDP volatility,
even after taking into account income level and
degree of openness. One reason may be that
smaller economies are less diversified and thus
more vulnerable to external shocks. However, GDP
may not be a good measure of income (or wealth)
for economies that are very open to trade. For
instance, the income of a commodity-exporting
economy could be determined largely by the world
price of its principal export commodity relative to
the price of the basket of goods it imports. Indeed,
the fluctuations in these “terms of trade” for
developing economies tend to be sharp and persistent,
reflecting, in part, the volatility of international
prices for primary commodity exports.

Terms of trade volatility is 30 percent higher on
average for small states than for other developing
countries (Table 3). Consequently, for small states,
the volatility of a measure of income growth that
incorporates the effects of such terms of trade
changes is even greater than that of output growth.

**Are small states different?**

*Per capita income varies.* Small states range from low-income
economies, such as Comoros, The Gambia, Guinea-Bissau, and São
Tomé and Príncipe (with per capita GNPs of less than $700), to high-
inecome economies, such as The Bahamas, Brunei, Malta, and Qatar
(with per capita GNPs of about $10,000 or more) (Table 2). Their per
capita incomes are, on average, higher than those of other developing
economies. Other indicators of economic well-being, including
poverty rates, life expectancy, and literacy, are similar for small states
and other developing economies.

*Trade is more open.* Small states are generally more open to
trade than other developing countries, and their average openness
ratio (exports plus imports divided by GDP) has risen signifi-
cantly over time. They also tend to have a less diversified production
structure and export base, with one or two dominant
products or industries. For example, garments represent more
than 80 percent of Lesotho’s total merchandise exports. In
Antigua and Barbuda, Barbados, Samoa, St. Kitts and Nevis, and
St. Lucia, tourism earnings constituted more than half of exports of
goods and services in the late 1990s.

*Large public sectors.* The size of government, as measured by
the ratio of government expenditures to GDP, is greater in small
states than in other developing countries. The economies that are
more open to external trade and, consequently, more vulnerable
to external shocks, tend to have larger public sectors, which help
counteract the short-term effects of such shocks. But small states
have higher ratios of government expenditures to GDP even after
controlling for per capita income and degree of openness, perhaps
reflecting the higher average costs of producing public goods on a
small scale.

*Strong trade links, but weaker financial links.* Over the past four
decades, average output growth has been higher in small states
than in other economies, the apparent result of their strong trade
links and their substantially higher investment ratios. Clearly,
small states have benefited significantly from trade openness.
Their financial links with the global economy are, however,
weaker. Although the average ratio of the volume of capital flows
to GDP is larger for small states than for other developing coun-
tries, it is still smaller than for industrial economies. In several
small states where foreign aid remains a major source of income,
aid dependency continues to be an important problem (Chart 1).
The average ratio of foreign aid to GDP is about 20 percent in
small countries, whereas it is less than 9 percent in other develop-
ing economies.

*Exchange rates tend to be fixed.* It would seem appropriate for
small states, given their vulnerability to external shocks, to use freely
floating exchange rates as a buffer. But this is generally not a feasible
option, and most small states have fixed exchange rates of one form
or another. One reason is that it is difficult to have a competitive
and well-functioning foreign exchange market with only one or two
major banks and little or no scope for open market operations.
In addition, many of these economies are closely tied to larger
economies that constitute a significant source of their export earn-
ings. In such circumstances, the benefits of eliminating nominal
exchange rate volatility by using a de facto fixed exchange rate can
exceed the gains of having an independent monetary policy and
having the exchange rate serve as a shock absorber.

Finance & Development / December 2002 39
Moreover, foreign aid flows to many small states are highly volatile and tend to be positively correlated with domestic GDP, partly because both aid flows and business cycle conditions in small states are affected by cyclical conditions in donor countries. Thus, despite the substantial benefits accruing from foreign aid, these flows may also contribute to income volatility.

However, output (or income) volatility is less of a concern than consumption volatility, a more relevant measure of welfare. It is well known that access to financial markets, which can be used to reduce the volatility of individuals’ consumption, greatly increases economic welfare. Similarly, a group of countries that do not have perfectly correlated output shocks (which they rarely do) should, in principle, be able to share their macroeconomic risk in such a way that consumption is less volatile than income in each country. If this were so, the high output volatility for small states would not be a great concern.

But are small states able to use international financial markets to reduce their aggregate consumption volatility? By one simple measure, no. In fact, in many developing economies, consumption is more volatile than income—on average, the standard deviation of their consumption growth is greater than that of output (or income) growth. The average ratio of the standard deviation of consumption growth to that of output growth is even higher for small states—despite their having relatively larger government sectors to help reduce the adverse impact of external shocks. The results on volatility reported in Table 3 are similar if the sample is restricted to the 1990s, the period of major financial globalization.

**Policy options**

The solution for these countries lies in their ability to take full advantage of increased integration with the global economy while maintaining sound macroeconomic policies and keeping their domestic markets and institutions flexible. The right policies could turn some of the macroeconomic and structural features of small states to their advantage and help them derive significant benefits from globalization.

**Trade and financial links.** Increasing integration with the world economy offers significant opportunities for small states. Trade links have already helped many of them increase the markets for their products and benefit from economies of scale. Openness to capital flows would offer them opportunities for diversifying into new sectors, increasing investment and growth, and achieving better risk sharing. Both trade and capital flows can also enhance the rate of technology transfer. Furthermore, globalization enables these economies to absorb and adopt best international practices in terms of governance and other institutional structures.

Developing stronger financial links remains a priority for small states. In particular, using global financial markets to reduce their consumption volatility could bring them significant welfare gains. Their best hope may thus lie in international risk sharing, through better integration with global financial markets. We estimate that, for small states, such welfare gains are potentially very large—equivalent to the effect of a permanent 15 percent increase in the level of consumption (Chart 2). These potential gains are larger for small states than for other developing countries because the former are faced with much greater consumption volatility.

**Sound macroeconomic policies and structural frameworks.** Of course, financial integration has its own risks. Minimizing these risks would require sound macroeconomic and structural frameworks, giving policymakers room to maneuver when shocks hit and ensuring that the shocks are not accentuated. As in other developing countries, structural reforms—better governance, lower corruption, better banking regulation, and increased

<table>
<thead>
<tr>
<th>How do they compare with other countries?</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1960–2000)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Relative income per capita (U.S. = 100)</th>
<th>Trade openness (percent of GDP)</th>
<th>Government expenditure (percent of GDP)</th>
<th>Investment (percent of GDP)</th>
<th>Output growth (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small states</td>
<td>24.9</td>
<td>111.5</td>
<td>20.5</td>
<td>28.0</td>
<td>5.9</td>
</tr>
<tr>
<td>Other developing countries</td>
<td>16.3</td>
<td>60.5</td>
<td>13.8</td>
<td>19.9</td>
<td>3.8</td>
</tr>
<tr>
<td>Industrial countries</td>
<td>75.4</td>
<td>63.3</td>
<td>17.8</td>
<td>23.9</td>
<td>3.4</td>
</tr>
</tbody>
</table>

competition—would boost capital inflows while reducing their volatility and mitigate the lingering effects of external shocks. Flexible fiscal frameworks would also help small states dependent on foreign aid flows to cope with flows that are highly volatile and hard to predict.

Two small states that have registered impressive average GDP growth over the past 30 years are Botswana (10 percent) and Mauritius (6 percent). These two countries are quite different, but, according to recent research, what they have in common are good governance structures and sound macroeconomic policies. In particular, Mauritius’s policies for foreign direct investment and Botswana’s long-term policies for improving infrastructure and education played central roles in their economic transformation.

Regional alliances. Some alliances of small states with similar economic structures (for example, the Pacific Forum and the Caribbean Community) have provided opportunities for pooling to reduce the costs of providing public goods and services. Such alliances are unlikely to help greatly in sharing risk because all members of the group would probably be subject to similar external shocks. Nevertheless, they have other benefits; for instance, they can help small states increase their bargaining power, as a group, in trade negotiations.

New financial instruments for hedging income risk. While increasing integration with world financial markets has the potential for generating substantial benefits, recent research suggests that absence of a rich set of financial instruments and associated “macro” markets, which are necessary to fully exploit these benefits, hinders further global integration of markets. One instrument proposed by several economists, including Robert Shiller of Yale University, would be indexed to national GDPs to enable countries to share their aggregate risk measured in terms of the volatility of GDP growth. A small state could use such instruments to diversify its country-specific risk by forming a portfolio whose return depends on the economic performance of several other countries. The welfare gains associated with trading such GDP-linked financial instruments could be enormous, but the complexities of creating benchmarks for measuring risks and monitoring outcomes may have deterred private capital markets from pursuing this course. The existing vacuum suggests a possible role for the international financial institutions in creating such markets and in providing monitoring and information services that would allow these markets to operate efficiently. In this context, development of certain insurance markets—for example, catastrophe insurance to cushion the effects of natural disasters—could be critical for small states, which are highly vulnerable to transitory, exogenous shocks.

Size matters

Ultimately, however, economic size does matter. Integration with the global economy, along with sound macroeconomic and institutional structures, may help small states attain higher output growth. But, given the imperfections in international capital markets, small states may ultimately not be able to use these markets to fully insulate themselves from external shocks or significantly reduce consumption volatility in the face of income volatility. Indeed, this suggests that the political fractionalization of countries into smaller autonomous units could have serious consequences in terms of national and global macroeconomic volatility.

M. Ayhan Kose is an Economist in the IMF’s Western Hemisphere Department, and Eswar S. Prasad is Assistant to the Director in the IMF’s Asia and Pacific Department.

This article is based on the authors’ IMF Working Paper with the same title, to be published in 2003.

References:

